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NEW DEFICIT ESTIMATES AND REVISING THE GRAMM-RUDMAN-HOLLINGS TARGETS

HEARING

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

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NEW DEFICIT ESTIMATES AND REVISING THE GRAMM-RUDMAN-HOLLINGS TARGETS

TUESDAY, JULY 14, 1987

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee convened, pursuant to notice, at 10:30 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Lawton Chiles (chairman of the committee) presiding.

Present: Senators Chiles, Exon, Lautenberg, Conrad, Domenici, Symms, Grassley, Nickles, and Gramm.

Staff present: Richard N. Brandon, staff director; and Jeff Coleman, junior analyst for budget priorities.

For the minority: G. William Hoagland, staff director; and Gail Fosler, deputy staff director and chief economist.

OPENING STATEMENT OF CHAIRMAN CHILES

Chairman CHILES. Good morning. The purpose of today's hearing is to sharpen the teeth of Gramm-Rudman-Hollings. We have to make it strong enough to work, and we have to make it compelling enough to make *us* work.

FIRST YEARS OF GRAMM-RUDMAN-HOLLINGS HAVE PROBLEMS

Gramm-Rudman-Hollings has been applied to 2 fiscal years so far. The total deficit reduction has been roughly half the intended annual target of $36 billion. So we have found a number of problems in these first years under the deficit reduction plan.

First, the original baseline deficit from which all of the reductions were to flow has been inaccurate. The deficit was some $50 billion higher than the law assumed. That helped make each of the annual deficit targets unrealistic and unreachable. So in effect, the flag was raised higher than we could climb the pole.

Secondly, when the Supreme Court struck down the automatic sequester provision, it took the guards out of the watchtowers, and where automatic sequester had made escape impossible, its removal changed the whole mood in Washington. We suddenly had a sense that there was a way out. Now there is an even more compelling reason for putting the force back in the law.

The Congressional Budget Office has produced new estimates for the deficit over the next 5 years, and in each of those years, they show us now that the baseline deficit is acutally higher than originally was assumed. In fact, in 1989, when the original Gramm-

Rudman-Hollings Act says the deficit is supposed to be down to $72 billion, the baseline deficit is expected to be some $198 billion.

SPENDING CUT AND TAX INCREASE NEEDED SIMULTANEOUSLY

That would mean the deficit would have to be cut approximately $122 billion in just 1 year, or nearly four times what we saved in this year's budget. It would mean we would not only have to have a massive spending cut, and not just a massive tax increase, but we would probably have both at the same time.

Think what these spending cuts would mean to key domestic programs for the young, the poor, the sick and the old, and then think what they would mean for our national defense. Think what massive tax increases would mean for all of us.

I understand the Congressional Budget Office will tell us today that the policies proposed in the President's budget will not meet the $108 billion target that the law prescribes. The deficit will not even meet the $135 billion included in the budget resolution. It will be roughly $152 billion. That would mean the same thing would happen with our targets as well.

The fiscal year 1988 deficit has already climbed by $18 billion. And if we were to point to the lower deficits in fiscal year 1987, we would not get much comfort, since those were achieved with one-shot savings. As a matter of fact, I expect the Congressional Budget Office to tell us without the one-year, one-shot savings, the fiscal 1988 budget deficit would be about $194 billion.

GRAMM-RUDMAN-HOLLINGS MUST WORK

So we have got to make Gramm-Rudman-Hollings work. To make the law work, we have got to fix a piece that is broken and replace a piece that is missing. In short, the deficit targets have to be revised, and automatic sequester must be restored.

We need to make sure that the deficit is reduced at least $36 billion a year every year until the deficit is gone. We need to make sure that it gets done. That means we either come up with a reasonable mix of spending cuts and revenues, or the automatic sequester kicks in and it does it all on the spending side.

To be blunt, without automatic sequester, Gramm-Rudman-Hollings has been used to frame the political debate rather than to cut the deficit. It threatens to become a lot more talk and a lot less action.

Since the deficit targets were unrealistic, we always ended up with a political "lose-lose" situation. No matter what we did, it was never enough.

Sometimes you have to take the heat in order to make something work, and I think that is where we are; this is one of those times. If somebody wants to play politics and jump on the revised targets, that is headline stuff. But when you pledge yourself to $36 billion a year in policy deficit reductions, without gimmicks, to me that is bottom line stuff, and either Congress and the President agree, or we default and get hit with a sequester.

If we make these changes—and I certainly hope we will; I intend to participate in offering them as an amendment to the debt limit

extension—Congress and the President will gain a new incentive to sit down and work things out.

Congress has taken a lot of criticism from an administration that has never sent a budget to Congress with an actual deficit that turned out to be lower than $134 billion. That does not get us anywhere.

I invite the President, again, to work with us. He sent us a budget in January. We gave it every chance. It was rejected by a bipartisan majority. Sixty percent of Senate Republicans voted against it. Congress has passed a budget, and the President has spurned.

TIME TO FIND COMBINATION

This is the time for cooperation. This is the time to find the combination of things that will eliminate the deficit once and for all, and there are two combinations that count. The first is the combination of defense and domestic spending and reductions there, and the other mix is with some revenues to reduce the deficit. The second combination is the President and Congress sitting down together. These two I think will unlock the vice of debt that is gripping the country.

We have seen that the deficit numbers are high, and the problems are large. But there is one thing I know for sure: Gramm-Rudman-Hollings gives us an opportunity to cut through politics. It opens the way for some needed structural change. I believe that, and I know the President believes it, because he is the one who said it on March 10, 1986.

The automatic sequester provision is the nuclear deterrent in the budget process. It is our job to make sure the bomb does not go off. It is there as a force, but we need to come to the negotiating table and find a way to make sure it is not used.

If we put aside the politics of accusation, stop talking about each other and start talking to each other, then I think we can get the job done.

I look forward to the testimony of Dr. Miller, Office of Management and Budget, and the testimony of Dr. Gramlich of the Congressional Budget Office.

Senator Domenici?

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. Mr. Chairman, I think if the U.S. Congress, or at least the U.S. Senate, is serious about reinstating the automatic sequester and wishes to do it in a constitutional manner, it is imperative that we set goals for ourselves that are realistic and achievable. That is what I perceive as the purpose of this meeting. We must see what the current best estimates for the 1987 budget are.

FEBRUARY AND JULY ESTIMATES DIFFER

We are always reestimating the deficit, and the only time we got a good break in reestimating was in 1987. In February, the deficit estimate was $176 billion; in July 1987,the reestimate was $161 billion. Something happened between February and July—either rev-

enues increased, or we did indeed reduce spending or we did sell assets. In any case, it appears to me that it is imminently important that if we are going to start down a new path with a new starting point, that we have the best possible estimates of the 1987 policy baseline from which we began a new path of 4 or 5 years of deficit reduction.

I understand that the estimate that the Congress was using and the estimate which the President was using are now subject to reestimating for various reasons. The purpose of this meeting, as I understand it, is to find out why the February and July estimates are different. I understand that they are different to the tune of between $10 and $11 billion, maybe as much as $13 billion. That is a lot of money. It means that the fiscal year 1988 budget that we have before the U.S. Congress, if implemented in its totality—which many of us obviously do not think should be done, at least in the manner that Congress recommended—would not reach even the $134 billion deficit recommended in the budget document.

The President's budget, whether we like it or not, estimated using CBO economics, would not reach the $134 billion deficit; it would also be off.

I assume we would reach a consensus here that both the President's and Congress' budgets are off by about the same amount, since both assume to reach about the same deficit, depending on which economics you use.

Therefore, I think it is extremely important that we know to the best of our ability where we are as we start down a new deficit reduction path.

OUT-YEAR DEFICITS CONTINUE ON A TREND DOWN

The most dramatic news that I already have is not that this year's deficit went up somewhere between $10 and $13 billion, but that the out-year deficits do not continue on a trend line down.

We started with an actual deficit of $221 billion in fiscal year 1986, and this year we are at $161 billion or thereabouts. In February, we thought we were at $171 billion for fiscal year 1988 and then going down—$164, $137, $110 billion in the out-years. As a matter of fact, the reestimating will show that instead of $171 billion, we are at somewhere between $179 and $182 billion. Then we have a very big increase the next year fiscal year 1989, assuming current policy. CBO now estimates we are at $198 billion for fiscal year 1989. That is a very, very important issue for the Congress, because we are trying to fashion a realistic fix.

I am interested in finding out why the numbers changed, not by way of criticism, but because I want to uncover the principal reasons for the changes in 1987 and 1988.

Thank you very much, Mr. Chairman. I look forward to trying in the next week or so to see if we can come up with a Gramm-Rudman fix that will work and that is realistic in terms of being achievable. We will find ways to get out of anything that is so far out that it is not achievable.

Thank you very much.

Chairman CHILES. Thank you.

This is a hearing of the Budget Committee to which we have also invited both Democratic and Republican members of the Budget Task Force. We are delighted to see some attendees here.

Any other opening remarks? If not, we will call on Dr. Miller.

Senator DOMENICI. Mr. Chairman, before we yield to Senate Gramm, might I say to the Senators, that the numbers in the chart have not been finalized by CBO. The chart is my staff's extrapolations. I am assuming that both CBO and OMB are going to come close to it. But those were the numbers I was reading from, in case anybody is interested.

Thank you.

Chairman CHILES.Thank you Senator Domenici.

Current Law Gramm-Rudman-Hollings Targets vs. Baseline Estimates

($ billions)

Fiscal Year	Current G-R-H Targets	Baseline Deficit Estimates CBO Feb. '87	CBO July '87 PRELIMINARY
1986	172	221 a/	- - -
1987	144	176	161
1988	108	171	179
1989	72	164	198
1990	36	137	184
1991	0	110	173
1992	0	85	160

a/ Actual FY 1986 Deficit

Prepared by Republican Staff,
Senate Budget Committee.

Chairman CHILES. Senator Gramm?

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Mr. Chairman, first let me thank you for asking those of us who are interested in this problem, who are serving on the task force on the Republican side of the aisle in the Senate, to participate in the hearings.

GRAMM-RUDMAN-HOLLINGS LAW HAS HAD IMPACT

I think we have made progress under the Gramm-Rudman-Hollings law. People ask me if Gramm-Rudman is a success, and I say, well, it depends on your definition. If you define the success of religion by the number of saints in the world, religion is a pretty dismal failure. On the other hand, if you define religion as to

whether the world is better off with it than without it, then it is a resounding success. And I think that by the latter definition, the Gramm-Rudman-Hollings law has had an impact. It is not clear what last year's deficit reduction is going to turn out to be, but I think we still have a chance of salvaging almost a $40 billion reduction in the deficit in fiscal year 1987. That would be the largest single-year deficit reduction in American history. We still have a fighting chance of achieving the lowest rate of growth in Federal spending of any year since 1955 when Eisenhower was President.

So I think it is clear that even with the problems created by the Supreme Court decision striking down the involvement of the Comptroller General, thereby removing the automatic mechanism as a disciplining device, Gramm-Rudman-Hollings has had an impact.

TARGETS NEED ADJUSTING

It is obvious, however, especially this year, that spending is on the rise, and that we need to go back and adjust the Gramm-Rudman-Hollings targets.

I would like to remind people that when we originally passed the law, it was our intention to have it start in 1987. We found ourselves in conference with people who said, "If this is a good idea in 1987, it is a better idea in 1986." Since we had passed a budget that called for a deficit of $172 billion, even though virtually everybody knew that the deficit was over $200 billion, we were forced to begin with that fiction. As a result, I think it is a fair statement to say that we have been about $30 billion behind the "power curve" from the very beginning.

If we can put the teeth back into Gramm-Rudman-Hollings, if we can have a binding process and automatic triggers, I am willing to make a one-time adjustment in the targets. However, I think we need to look very closely at what we are doing. I expect to have some targets that can assure that there is pressure to lower the deficit. And while I am willing to look at any and all proposals, I like specified targets where we know what we are committing to and where the public has some ability to judge our success.

Chairman CHILES. Senator Exon?

OPENING STATEMENT OF SENATOR EXON

Senator EXON. Mr. Chairman, it seems to me that one of the key weaknesses of the Gramm-Rudman-Hollings plan is that it is a useful tool to reduce deficit estimates, but it has been a meager tool in reducing deficits.

If you look at the first 2 years of operation produced by this bill, it has created the largest record deficit in history in 1986 and a high, considerably reduced deficit in 1987 through 1-year asset sales, spending shifts, and accounting gimmicks. By focusing on future estimates of the deficit target 1 year at a time with no follow-on maintenance, you actually encourage the use of accounting gimmicks rather than serious deficit reduction. Under the Gramm-Rudman-Hollings law, there is no penalty for increasing the national debt.

DEBT CEILING REFORM ADVOCATED

I advocate a debt ceiling reform which would incorporate debt ceiling legislation into reconciliation if Congress or the administration exceeds their planned borrowings. A three-fifth vote would be needed.

This would discourage the use of optimistic economics and temporary debt ceiling reduction and would encourage a monitoring of the Nation's economic policies. And I would appreciate when his time comes for the distinguished chairman, who I am pleased to welcome here today, to hear what he feels about this issue.

I see that we are coming down once again to the debt ceiling crisis, and once again we are going to use what we did originally, and that was to raise the debt ceiling and, using Gramm-Rudman-Hollings program, workable or not, as a crutch. And I think that it is time that we call a halt to all that. It seems to me if we are looking for a trigger, the place to have that trigger is when the Congress, as it is going to have to from here on out, every time we want to raise the debt ceiling, that should be the trigger. That is the time when the Congress, and not some nonelected bureaucrat, is charged with the responsibility of making the cut. It is up to us to make the cuts, or it is up to us to raise the revenues to cover what I think is becoming a rather staggering shortcoming of the whole process.

Certainly, Gramm-Rudman-Hollings is well-intended. I think that we are continuing to seek for an enforcement mechanism, and I think it is right there, staring us in the face, if we would look at forcing us to make the decisions every time we raise the debt ceiling when we are obviously out of whack with projection.

Thank you.

Chairman CHILES. Senator Lautenberg?

OPENING STATEMENT OF SENATOR LAUTENBERG

Senator LAUTENBERG. Mr. Chairman, briefly, I am pleased to see our colleague invited here this morning, a prime author of the Gramm-Rudman-Hollings budget program.

BAR TO HIGH

I would have to challenge, however, his perspective on what caused the lower deficit. When the bar is so high that no one can jump over it, the tendency is to disregard it as being insignificant in terms of an objective.

I would urge the Senator from Texas, who commands a great deal of respect and a great deal of influence within his party on budget matters, to encourage us to get into truth-in-budgeting and to get the President and the Republican Members of the Senate and the House to sit down in earnest to try and do something about this and not hold the Damocles sword over everybody's head with veto threats or "make my day" or what-have-you.

This is a problem that we all face. It is deeper than many realize out there in the countryside.

I think we risk a major economic reversal if we do not solve this problem. And it will not get solved by contraptions or process reform or what-have-you. It will get solved when everybody partici-

pates, stands up and takes the political consequences of acting, of raising revenues and trimming programs. That is when it is going to happen, and we are not going to have a magic wand that is going to solve it, with all due respect to the Senator from Texas who worked so hard on this.

I think what we have seen now is a year in live mode in which it does not work, and that is the realization that we are coming to. It may have helped keep a pebble in the shoe; I will not deny it. But again, to use my analogy of the high bar, the bar was so high that neither the President nor the Congress could reach it.

No one is going to achieve it the way it is proposed. To sequester would put this country, in my view, in to a deep recession, and no one believes otherwise. So, what we are doing is holding this thing out as a fictional guillotine that is supposed to bring it all into place through the threat of punishment. It is not going to happen, and I suggest, Mr. Chairman, that the sooner that we get on understanding that this has to be a cooperative process, the better off we'll be.

Chairman CHILES. On that note, I would like to see if I could get to Mr. Miller's testimony. He has a time deadline. I do not want to cut anybody off. But if we could save our discussion, maybe.

Mr. Miller, we are delighted to have you before us as the Director of the Office of Management and Budget.

Senator DOMENICI. Mr. Chairman.

Chairman CHILES. Yes, sir.

Senator DOMENICI. I just want to say from the standpoint of this Republican, I do not need any lecturing from the other side, whether it be from the man at the end or anybody else, about how to put a budget together, and standing together and working together—I do not need any of that. I have chaired this committee myself, and sometimes you all have not helped, and sometimes you have. We put a budget together with one Senator from your side that was a real budget. Our own President let us down, I will agree on that. But we just happened to disagree this year on how to put a budget together. Hopefully, we can put together a deficit reduction fix that has a realistic chance of working.

In deference to Mr. Miller's time, I will keep my remarks that brief. Thank you very much.

Chairman CHILES. A strong letter follows.

Mr. Miller?

STATEMENT OF HON. JAMES C. MILLER III, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Dr. MILLER. Thank you, Mr. Chairman.

I appreciate your inviting me here today and I also appreciate your accommodating my schedule. I noted with interest your invitation to get together to discuss a budget process reform, the Gramm-Rudman-Hollings fix. I want to tell you that my schedule is open completely from noon to 4 o'clock, and I would be more than willing, anxious, to meet with you at any time within that time frame; I will even go without lunch if we can sit down and work on the Gramm-Rudman-Hollings fix.

Chairman CHILES. Could we broaden that discussion a little bit and talk about a lot of other things at that time? If you have got some time, we would like to have a broader discussion.

Dr. MILLER. Well, I think it would be important to talk about budget process reform and this fix; that is the first order of business, and I would like to talk about that.

The issues that you have before you, I think, are vitally important. I would like to make several points from my notes and then respond to your questions.

CHARACTER OF DEFICIT PATH

The first topic I want to address is the character of the deficit path. Shortly after I took the job at OMB back in late 1985, both OMB and CBO were reporting that the current services deficit was falling, primarily because of substantial downward revisions in defense spending estimates and lower interest rates.

OMB, for example, had the deficit going from $206 billion in fiscal 1986 to $104 billion in fiscal year 1991. That was the current services deficit.

CBO's calculations were $208 billion down to $104 billion.

Senator DOMENICI. By which year?

Dr. MILLER. By 1991.

CBO's current services deficit numbers are up there. CBO estimates, and now as a preliminary matter, we agree, that the current services deficit will no longer be falling over the next 3 years.

LEVEL OF DEFICITS

The second point I would make is in terms of the level of deficits. In August 1985, the fiscal year 1986 deficit was projected to be $175 billion according to CBO, assuming the implementation of the Congressional Budget Resolution. According to OMB, it was $178 billion assuming the enactment of the President's budget.

As we all know, the fiscal year 1986 deficit turned out to be $221 billion, even after a $12 billion sequester. Thus we are now faced with a situation somewhat different than many presumed to exist when Gramm-Rudman-Hollings was enacted into law in December 1985.

Now, how did this happen?

LEVEL OF CURRENT SERVICES DEFICIT

Let us take the level of the current services deficit first. As just noted, the fiscal year 1986 deficit turned out to be much higher than expected. Current services deficits for the outyears were also increased. The major reasons for the increases were: the budget enacted in fiscal year 1986 was neither the President's budget nor was it consistent with the Congressional Budget Resolution; technical reestimates of agency programs elevated projected spending; economic performance did not measure up to assumptions.

Now, as regards the character of the current services deficits, tax reform decreased the 1987 deficit, but is predicted to have little effect in 1988.

Last year's reconciliation provided substantial offsetting receipts which in effect were one-time increases in revenues.

And last year's reconciliation also contained several program expansions, particularly in the medicare area.

Now, given these changes, where do we go from here?

ADJUST TARGETS

First, I think we should recognize that many want to adjust the targets, as has been discussed this morning, to reflect the higher starting point for the fiscal year 1986 deficit. And if you add back in the $12 billion sequester, you come up with a figure of $232 billion or $233 billion, not the $220.5 or $221 billion figure that was recorded including the sequester.

Although the administration has not advocated this, I should note that adjusting the targets upward would certainly make meeting the targets easier.

INCREASE REVENUE, NOT TAXES

Second, we should be prepared to get serious about increasing revenue and/or reducing outlays. Now, I did not say increase taxes, let the record show.

The President's budget for fiscal year 1988 raises revenue by some $22 billion. A little less than half of that is one-time revenue; the rest is recurring revenue.

Now, we can work with you to identify alternative sources of revenue on this scale, but please do not ask us to increase taxes.

Also I must express my keen disappointment that Congress has adopted so few of the President's revenue proposals. For example, the sale of the National Petroleum Reserve is estimated to bring in $3.3 billion. And why is the Federal Government in the oil business?

Application of meat and poultry inspection would bring in something like $400 million in user fees from meat and poultry inspection. This is an ordinary business expense in other industries. Why should taxpayers subsidize the meat and poultry industry and their customers?

Now, the first item I just gave, on NPR, is a one-time revenue; the second one would be a recurring revenue.

Of course, I have heard it said that no more cuts can be made. I think this is preposterous. Do we need to spend $332 million to fund programs in a time of budget stringency like "urban gardening" and "pest management"?

Do we need to subsidize Amtrak to the tune of half a billion dollars a year, or a $27 subsidy every time somebody steps onto a commercial intercity train in this country?

Do we need to spend $4 million on something called "salmon enhancement"?

Finally, do we need to spend $8 million on a national center to study weeds?

Now, I am keenly aware that the major issue before you today is about the Gramm-Rudman-Hollings fix, so let me turn to that.

INSTITUTIONAL CHANGES NECESSARY

First, I think that we all recognize that some institutional changes will be necessary to assure real progress in reducing the

deficit. But I want to come back to something that was said earlier. We have made a lot of progress. If you go from $221 billion even after a $12 billion sequester, down to an estimated $175 billion or less, that is terrific progress, and you have to give Gramm-Rudman-Hollings, I think, a majority of credit for that.

You know, when the President sent up the budget last January, we estimated on a policy basis, a $173 billion deficit for fiscal year 1987. That included savings of about $2 billion from rescissions and deferrals, most of which Congress did not approve. So the relevant number is $175 billion.

Mr. Chairman, we will make that $175 billion figure or beat it this year.

Chairman CHILES. Mr. Miller, you are taking great advantage of the tax reform which added $18 billion and one-time savings of $16 billion. I think what the figures are showing us is that the whole baseline is turning the other way.

You are claiming credit for some things that are not going to recur, one-shot operations.

Dr. MILLER. Well, Mr. Chairman, I remember an old television jingle that went, "They said it could not be done; they said nobody could do it, but we did it." And I think we can do it again next year if we just muster the strength to address the deficit question.

We need some kind of institutional change, but the question is what kind. It seems to me that three goals ought to be pursued. First, the sequester should not even enter the picture. That is, Congress on its own, with the President, should do the job of bringing the budget into balance, reducing the deficit incrementally over a period of several years to bring it down to zero.

Also, I realize there is strong support for some adjustment in the targets that will make a sequester less needed, less relevant.

ENTER SEQUESTER WITH GREATER RELUCTANCE

Secondly, we need to enter a sequester only with the greatest reluctance and where responsibility is clearly understood. Both Congress and the President should be seen as responsible, not just the President. For this reason, the approach of having a sequester materialize out of nowhere, for the President to approve or disapprove, is simply unacceptable. On this score, I am also troubled by some of the other automatic trigger mechanisms being discussed.

More should be put in the sequester base—all except prior year obligations, interest on the debt, and social security.

The responsible thing would be to hit defense and non-defense, not 50–50, but in relation to their respective increases during the past several years—that number is more like 40–60 percent of total outlay growth since 1984. The defense budget has gone up, but what people do not generally understand is that non-defense spending has gone up even more.

MAXIMUM FLEXIBILITY SHOULD BE AFFORDED

Third, in case there is a sequester, the Executive should be afforded maximum flexibility to carry out as best he can the laws of the land with minimum disruption.

Then we need to reinstate defense flexibility as it was in fiscal year 1986 for that sequester. We need to give the President unlimited enhanced recision authority in case there is a sequester. As you know, Mr. Chairman, this is merely giving the President the option of sending up a proposed set of outlay reductions and forcing Congress to vote either up or down, 50–50, up or down. All you have got to do is have 50 percent in either House, and it is dead. But at least give the President that kind of flexibility.

NEED FOR BUDGET PROCESS REFORM

I must tell you, Mr. Chairman and other members of the committee, there is something transcending all of this, and that is the need for budget process reform.

Budget process reform would reduce the cost to all of us of orchestrating a budget. Indeed, budget process reform would enable us to negotiate a budget. Specifically, we need a vote on a balanced budget amendment and a line item veto. We need enhanced rescision authority. We need conversion of the Congressional Budget Resolution from a mere concurrent resolution which is what it is today—only an agreement between the two Houses of Congress—to a joint resolution that officially brings the President into the process. Why ask the President to come into the process when he has no stake, he has no voting power, he has none of the usual procedures we have on making these kinds of agreements?

We need enforceable 302(b) allocations, defense versus non-defense.

We need scoring of outlays as well as budget authority by the House of Representatives as you have in the Senate.

We need biennial budgeting, especially for defense.

We need strengthened reconciliation, an issue Majority Leader Byrd has talked about.

We need requirement for separate appropriations bills, instead of sending down the President one humongous appropriations bill that says "Take it or leave it, Mr. President; shut down every facet of the government or sign this bill", we ought to at least have the 13 separate appropriations bills sent down to the President so he can deal with them separately.

Finally, we need the adoption of the President's proposed program of credit reform.

In fact, we are so keen about the desirability of budget process reform and think it is such an integral part of our collective approach to reducing the deficit that we believe that a simple fix of Gramm-Rudman-Hollings without budget process reform is unwise.

Let me say that again. We believe that a simple fix to Gramm-Rudman-Hollings without budget process reform is unwise.

AVOID DEFAULT

The final thing, Mr. Chairman, is the importance of avoiding a default. The higher debt limit, as you know, expires on July 17, and unless that is extended, the U.S. Treasury will default during the last week of July. The consequences of such a default would be devastating on the U.S. position around the world and on the long-

term cost of debt servicing. Moreover, there is no good reason to run the risk.

Thus, while we have been and continue to be willing to negotiate an acceptable Gramm-Rudman-Hollings fix and budget process reform, we urge Congress to separate the two issues and promptly pass a clean debt ceiling, and I would urge it be a long-term ceiling rather than a short-term ceiling.

Thank you, Mr. Chairman, and members of the committee and guests. I will be happy now to respond to your questions. I do have a meeting with the Vice President that just started.

Chairman CHILES. Dr. Miller, I understand that OMB is currently working on its midyear budget estimates and that your numbers are not yet final. I would like you, however, to give us some of your preliminary estimates with the understanding that they may change in the coming weeks.

OMB AND CBO NUMBERS NOT FAR OUT OF LINE

Assuming current law policies, what is actually referred to often as "current services," could you tell us whether your estimates of the 1988 and 1989 deficits are in the same ball park as CBO's estimates?

Dr. MILLER. Well, Mr. Chairman, I appreciate your recognition that I cannot give specific numbers. And I have found from experience that giving specific numbers is a big mistake, because even if they are very tenuous and tentative, people forget the caveats put on the numbers, and they tend to be thought of as firm. Then, when they are changed later, somebody presumes that they were changed for some reason other than the real reason.

I would say that I do not think there is any question but the baseline deficit for fiscal 1988 and for fiscal 1989 has risen since we issued the reports, since the President submitted the budget last January.

I do not see, at least for 1988, the Congressional Budget Office numbers being terribly out of line. I do have a feeling that the 1989 number is just a bit high, but I just simply will not be able to give you numbers until we have finished our mid-session review. As you know, we go out to the agencies and ask for detailed estimates of each of their programs, how much their programs are going to cost based on economic assumptions that are still not yet final, and we put the whole package together. Then, we will indicate what additional savings would be necessary, the released estimates will come back in, and we will publish the mid-session review around the middle of August.

We need to incorporate the effects of reconciliation. The bill that the President just signed on Saturday, we need to incorporate the rebasing of——

Senator DOMENICI. You mean the supplemental.

Dr. MILLER [continuing]. Excuse me, supplemental. We need to incorporate the rebasing of certain of the GNP figures that will be out next week.

We need to incorporate the knowledge of what the preliminary estimate is going to be on the second quarter, and that will not be out for a while yet.

We need to pull all this together before we can publish our numbers, and I simply cannot tell you without having that information.

Chairman CHILES. Well, the former top official at OMB, Kathy Eickhoff, recently left OMB, and claimed the administration's proposed budget for 1988 would fall more than $25 billion short of the Gramm-Rudman-Hollings deficit target of $108 billion.

Since the submission of your budget in January, the administration has repeatedly urged Congress to enact the proposed budget, claiming the budget reached the target. At the same time, we saw highly respected forecasters such as the Congressional Budget Office estimating your budget would save some $27 billion, less than you claimed.

DOES ADMINISTRATION BUDGET HIT TARGET

Do you still think the administration's budget hits the $108 billion target, and would $10 to $15 billion in additional cuts that some in the White House have suggested even make up for the Eickhoff memo's shortfall let alone this revised projected shortfall we are now discussing?

Dr. MILLER. Well, Mr. Chairman, Kathryn Eickhoff is a splendid economist. The leak—the unauthorized use of her memorandum—is simply case study in why it is unwise to ask the kinds of questions that that memo was addressing. That memo was saying if you made certain assumptions, different assumptions about growth and employment et cetera, what the effect on the deficit would be. She ran through the exercise and came out with the number. That was not a forecast; that was an exercise. Someone took this piece of paper and mischaracterized it terribly in that vein.

But on the other hand, let me address the specifics. And that is, as I indicated earlier, I do believe there has been a drifting upward of the current services deficit——

Chairman CHILES. I thought that was a memo she left on her desk as she left to go back into the private sector to sort of cleanse herself when she walked back through the looking glass to the real world and started saying what the real facts were.

Dr. MILLER. Ms. Eickhoff is a very loyal person, and I do not think for a minute that she left it on her desk purposely, to have it leaked. It was mischaracterized. But I have to tell you, Mr. Chairman, that we have memos such as this prepared relentlessly, just to give us some idea of the sensitivity to various changes in assumptions, et cetera. These are prepared at OMB daily, and sometimes, inadvertently, something like this gets out.

But as I have indicated, the baseline deficit has risen somewhat. As you know, our estimate of the President's deficit reduction package goes from $175 billion down to $108 billion, and it does that by about a $25 billion growth dividend; that is, under our assumptions, revenues will increase by a little over $68 billion in fiscal year 1988, outlays will increase by a little less than $44 billion. So you have got about $25 billion there, that brings it down to a baseline of $150 billion, a current services baseline of $150 billion. And from there, you have got $22 billion of revenue, and then you have got $20 billion of reductions, $1.3 billion of which is re-

duction in the cost of carrying the debt; because of lower debt, you have lower interest expense.

Now, if you have got that kind of package, that $42 billion package, and the baseline rises, then that means that the deficit number is a little over $108 billion. But it could have gone the other way. If growth had been higher, the baseline deficit had come down, we would be coming in under $108 billion. But what we did in this package is follow the law. We produced a budget. The President submitted a budget in January that met the $108 billion target. That was what was required by the law. In the mid-session review, there will be a requirement that we meet the law, and that is what we will do.

The President has a Cabinet meeting scheduled for this Thursday to discuss this very issue.

Chairman CHILES. Well, I guess the answer is that you do not think now that you will hit the $108 billion target.

BUDGET WILL MEET TARGET IN MID-SESSION REVIEW

Dr. MILLER. What I am saying, Mr. Chairman, and I want to be very careful about this, is that it appears now because of variances in economic performance from assumptions and some technical reestimates, the President's budget as submitted last January falls short of meeting the $108 billion target. But in the mid-session review, which we will release in August, pursuant to law, we will produce a budget that meets whatever target does exist.

Chairman CHILES. Presidential spokesman Marlin Fitzwater said last week that the administration believes the Gramm-Rudman-Hollings deficit targets ought to remain where they are. Assuming your new baseline estimates are in the same neighborhood of CBO's, we would have to reduce the deficit by more than $70 billion in 1988. How does the administration propose to achieve this monumental task?

Dr. MILLER. Well, Mr. Chairman, you ask a great leap of faith. You ask me a hypothetical. I do not necessarily assume that the CBO baseline numbers are correct. We do not know what those numbers will be. We will make the estimates later and make a determination.

But if I could just point out—this is not the kind of exercise that I would like to go through. It is not something that I pray for. It is not something that I dream about, because cutting substantial sums from a budget is not an easy process, as we all know. But if you look at the numbers, like $233 billion, and if you come down to somewhere close to what CBO is estimating as the deficit for fiscal year 1987, i.e., something like $161 billion, you will have cut more than $70 billion.

Let me just say that again. If you talk about the deficit for fiscal year 1986 before the $12 billion sequester, and you take that number and subtract the $161 billion, you have got a little over $70 billion. I am not saying that is an appropriate comparison. I am not saying it would be easy. But I am saying that at least it is in the realm of some possibility.

I do not want to go through that kind of cut, but again, that is assuming that the numbers that CBO has come up with in terms of

baseline deficit are correct, and that assumes that you make no change in the underlying targets, both of which I think are hypotheticals.

Chairman CHILES. Well, of course, I was talking about Fitzwater. I yield to Senator Domenici.

Senator DOMENICI. I understand you are on a short time frame, Mr. Director. Are you already behind schedule?

Dr. MILLER. Yes, sir, I am.

STAND-ALONE PIECE OF LEGISLATION

Senator DOMENICI. Well, let me just do this, if I might, with you. We are trying very hard to work with the administration, with Senator Chiles, and the leadership on his side to put together some kind of package here on Gramm-Rudman-Hollings, and so I understand your position. If I understand you correctly, the President prefers that we accomplish this "reform," on another bill, not on the debt limit; is that correct?

Dr. MILLER. Well, I have no problem at all with the Gramm-Rudman-Hollings package being a stand-alone piece of legislation. I am just saying that it is dangerous to put something like this, controversial, on a debt ceiling not only because of the trouble it could cause in terms of the possibility of defaulting, but also the scare that it would create.

Senator DOMENICI. I think we all understand that. The problem is that a number of people on our side of the aisle—I am not sure about the other side of the aisle—voted for a clean debt limit last time on the basis that the next limit through would be used for some kind of Gramm-Rudman overhaul and for some kind of budget reform. So I hope you understand the problem we have.

Dr. MILLER. Yes, sir.

Senator DOMENICI. I understand that you are saying the President would prefer some additional reforms in the process along with a Gramm-Rudman fix, so as to make the whole package more enforceable and more credible; is that correct?

Dr. MILLER. That is correct.

Senator DOMENICI. And that you would like some defense flexibility; is that correct?

Dr. MILLER. That is correct.

Senator DOMENICI. I understand all of that. However, in the U.S. Senate, we do not have a special rule for the debt limit. We are not going to pass a debt limit bill, it appears to this Senator, that is free of amendments. Rather than watch our country go into default, we might pass something short-term. But absent that, we are going to have some amendments on this bill.

TARGETS ARE FEASIBLE

Now, having said that, I do not understand your reluctance, Mr. Miller, and with all deference, to just plain forthrightly tell us that the current targets really are unachievable and must be changed. I just do not believe that you sit there and say "maybe," and that you need a mid-session review before you can decide.

Frankly, you can not really believe that we can get to a number that is in the current Gramm-Rudman-Hollings schedule, having

started as far behind as we started. I don't understand why you do not at least say that any workable Gramm-Rudman-Hollings has to have the deficit targets modified.

You are not suggesting that the President is going to be opposed to a Gramm-Rudman-Hollings fix on the basis of target changes, are you?

Dr. MILLER. Let me just try to amplify and explain my comment, Senator Domenici.

I think that getting down to the original Gramm-Rudman-Hollings targets is possible, is feasible, because if you let the President put together the budget, it is eminently feasible.

But I would say this. Given the way that the baseline deficits are being estimated by CBO, which are reflective of underlying causes that OMB recognizes and others in the administration recognize as well, I think it is politically unlikely——

Senator DOMENICI. And that you recognize.

Dr. MILLER [continuing]. And that I recognize, that OMB and I recognize—I think it is politically unlikely that we will be able to reach those targets without a sequester.

BASELINE DEFICIT CREEPING UP

Senator DOMENICI. Could I ask you, even though you are terribly reluctant to give numbers, does it sound somewhere right to you that the mid-session review deficit for the 1988 budget is somewhere in the neighborhood of $179 to $181 or $182 billion?

Dr. MILLER. Well, let me say, we have a different estimating methodology. For example, there are certain things that we count that the CBO does not count, et cetera. As I recollect, their baseline deficit last January was $176 billion or something of that nature, and they have essentially added $10 billion to that.

Our starting point was $150 billion. So if you added a similar amount, you would see that we are talking about something in the nature of $160 billion, but that is a back-of-the-envelope kind of calculation that has nothing to do with the process that we are going through right now, and it is only after we go through that process that we would come out.

But I would say that, as I indicated, there has been some creeping up in what we call the current services and what CBO calls baseline deficit.

Senator DOMENICI. Thank you, Mr. Chairman.

Chairman CHILES. Senator Exon?

PASS CLEAN DEBT LIMIT BILL

Senator EXON. Mr. Miller, I take it from your comments that you think that in passing the debt ceiling bill this year, we should not incorporate a triggering mechanism because it would be too complicated, as I suggested in my opening remarks?

Dr. MILLER. Senator Exon, what I would propose we do is to separate out the debt limit legislation and pass a clean debt limit, but also work feverishly to pull together budget process reform and a Gramm-Rudman-Hollings fix. As I indicated, an institutional change is needed to provide, I think, the kind of incentive to do

something real and dramatic about our continuing progress in deficit reduction.

I am concerned that the automatic trigger mechanism be one in which it is clearly understood that the responsibility is at Congress' door as well as the President's door if we end up having a sequester. But I think some kind of fix is appropriate. We have agreed to that. We are not walking away from that one iota.

Senator EXON. I only say, following up on what Senator Domenici was trying to get across to you, it is pretty obvious that the debt ceiling bill would not have passed last year had the Republicans not rounded up the votes to hide behind the skirts of Gramm-Rudman-Hollings.

Are you suggesting that the Congress muster the courage this year to just extend the debt ceiling to a higher amount, as requested by the President and address that and that issue only?

Dr. MILLER. No, sir. I think we ought to do all three. We ought to have a Gramm-Rudman-Hollings fix; we ought to have budget process reform, and we ought to extend the debt ceiling. The question is how to accomplish that.

I think we ought to extend the debt ceiling separately, because there is a concern that we get close to a default. You see, we are 2 days away, or 3 days away, from the debt ceiling ending, the debt ceiling falling from a higher level to a lower level. Now, we will not run out of money, we will not technically default until the end of July, at least according to current estimates. But that is a big issue, and I think we probably ought to treat that separately, but we ought to work to budget process reform and Gramm-Rudman-Hollings fix.

QUIT USING POLITICAL GIMMICKRY

Senator EXON. Well, we have got to be realistic, and I do not know how realistic you are being, Mr. Miller. I think politics is playing a key role in all of this. You remember the President came into office and said he was going to balance the budget by 1983, and yet we have had seven consecutive budgets from this President, some of them that you helped put together, that does not begin to balance the budget.

Now, I am for, as you know, a line item veto. I am for a constitutional amendment to balance the budget—all of these things that you want and the President is running around today, trying to make a lot of hoopla over, I think to cover up the dire straits that we face.

Add up for me the recommended cuts that you testified to in your opening remarks this morning with regard to Amtrak and salmon assistance and all those things. Add those up for me, or have your staff add them up for me. I would like to know what the totals of those were.

Dr. MILLER. Well, it is a little over half a billion dollars.

Senator EXON. Half a billion dollars.

Dr. MILLER. Half a billion dollars—but those are only examples.

Senator EXON. Wait, now, just a minute. It is over half a billion dollars, and we are facing somewhere between $50 and $60 billion that we have got to cut.

What I am saying to you, Mr. Miller, is that you are using the political out of coming up with a few small, possible—and I use the word "possible" advisedly—wishful programs, and you are saying, see, if you do that, you can balance this budget.

There is no way we are going to balance this budget, no way we are going to get to the Gramm-Rudman figures; there is no way we are going to make a significant downward trend in this unless we get realistic and quit using the political gimmickry that is used not only by you but by others, and quit trying to fool ourselves that this job is going to be easy.

I wanted to bring up that point of totalling up the cuts that you have made to show how insignificantly small they are with regard to the problem that faces us. We have got to get realistic, and I wish we could all join together and put politics aside and call the President off his ramblings around the country that are not doing anything to reduce the deficit, but it may be good politics—but I doubt that.

Dr. MILLER. Mr. Chairman, your characterization of "ramblings," I would characterize it as words of wisdom. Every journey begins with a few steps, and the argument is we cannot go any distance down that road, we cannot cut any more. Well, I have just given some examples of things that we can cut.

Senator EXON. How much? How much?

Dr. MILLER. Three examples, and that is a little over half a billion dollars. It was $4 million and $8 million plus half a billion. But there are lots of other things in the budget.

Senator EXON. In other words, we have only got about $40 or $50 billion more to go.

Dr. MILLER. That is right. [Laughter.]

That is right. If you will look at——

Senator EXON. Well, that is a very tiny step indeed, I suggest.

PRESIDENT'S PROPOSAL WOULD LOWER DEFICIT

Dr. MILLER. Well, I tell you, we can take some giant leaps, if you will look at the President's budget and things that he has proposed to cut, reforms that he has proposed in entitlement programs and additional revenue that he has proposed, all of which have been rejected by Congress; there are some giant leaps that will bring that deficit down.

I hope that we can work together in the mid-session review and take the proposals that the President has, and that Congress will enact them. That is a giant leap forward.

Chairman CHILES. Senator Nickles?

Senator NICKLES. Mr. Chairman, thank you. Mr. Miller, thank you as well.

I am very concerned about the projection figures that we are looking at Senator Domenici touched on them, but I think we desperately need reforms.

KEEP DEBT LIMIT EXTENSION AS VEHICLE

I heard you mention that you would like to see a clean debt limit and not see the reform package included. But many of us are afraid if we do not have it attached to the debt limit extension, we

will not get a final reform package. I personally think that if we do not get a reform package, we have missed a serious opportunity. We need those reforms.

I also heard you say the Gramm-Rudman fix without reforms was unsatisfactory. I think we definitely need both. And I am working with Senator Chiles, Senator Domenici and others in trying to put together at least some elements that we think can pass this session. I really do not know that we can afford to give up the debt limit as a vehicle for a budget reform package. It happens to be one vehicle that we need. If we had not used the debt limit before, we would not have gotten the original Gramm-Rudman. You are well aware of that. I wish it were not the case that we need a crisis-type atmosphere in order to make some significant changes, but I think we are going to.

You mentioned one of your proposals for budget process reform which I think is only one of many necessary reforms. Mr. Chairman we have discussed this briefly, that would allow the President basically, to be able to sign or veto each appropriation bill in a CR. I think we need this as a bare minimum reform, in addition to the Gramm-Rudman fix, this year. I would like to see others as well.

I think both the chairman and Senator Domenici have a lot of good ideas for budget process reform that we need to implement, but I cannot see giving up the debt limit extension as the vehicle. As a matter of fact, if my memory serves me correctly, the last time we had the temporary debt limit extension, it was on the premise that it would give us time to work out some of these reforms, and the debt limit extension was going to be the vehicle. So I personally do not want to see us give it up. I am afraid if we do, we will never have any reforms.

Dr. MILLER. I understand your views, Senator.

CONTINUE ON PRESENT GROWTH PATH

Senator NICKLES. I look forward to your reestimations, too. You made a couple points and Senator Domenici made a couple points concerning where we were going. You said we had growth revenues anticipated of about $68 billion.

Dr. MILLER. Yes, that is right.

Senator NICKLES. Growth revenues of $68 billion, and you thought spending increases were going to be $25 or $30 billion.

Dr. MILLER. $44 billion.

Senator NICKLES. $44 billion.

Dr. MILLER. So it is $25 billion difference.

Senator NICKLES. Well, the real reason why you saw the reduction—and correct me if I am wrong—but from the $221 billion now to the $170 billion or something in that neighborhood, from last year to this year, was because total spending grew at about $25 billion, and revenues grew at about $80 billion. Is that close?

Dr. MILLER. For 1986. I do not have the numbers, but you are right; there was a dividend.

Senator NICKLES. Growth revenues exceeded growth spending for the first time in years.

Dr. MILLER. Yes, right.

Senator NICKLES. We need to continue that path, and whether you are talking about cutting half a billion or a few million, really, what we need to do to get us on track is to have spending growth less than, say, $30 or $40 billion and have revenues grow as they are anticipated, and as they have for the last several years, around $75 or $80 billion.

Dr. MILLER. Senator, could I just point out, you are absolutely on target on this, because let me tell you how important growth of the economy is to all of this, because if we had zero growth, those numbers, that character of that current services deficit would zip up very fast.

We are now in the 55th month of an economic expansion. We are very close to setting a peacetime record for growth of the economy. But we have threats to the economy. I believe if we were to raise taxes, open the tax code so soon after having gone through all of the tax reform, if we were to be seen as giving up on deficit reduction, if we got truly protectionist trade legislation, and we did not manage our macro affairs correctly, we could threaten that economic expansion, then we would be in very big trouble.

Senator NICKLES. Thank you, Mr. Miller.

Chairman CHILES. The one thing you do not bring out, Mr. Miller, in this 54 months of tremendous expansion that we have had, we have also had this tremendous expansion in the deficit, because we have continued to borrow more money.

Senator Conrad?

TIME FOR FUNDAMENTAL CHANGE IN DIRECTION

Senator CONRAD. Let me just follow up. I think we are in big trouble now. I am just amazed that you are coming in here and talking about us maybe being in big trouble. We are in big trouble. We are in staggering trouble. The national debt has doubled in 6 years. The most incredible set of miscalculations perhaps in the history of civilized government—and now we get a continuation of it here today.

We have got a trade deficit that is out of control. I think we all know that 85 percent of it is because this national deficit is out of control. And I, for the life of me, do not understand why you come with these new numbers, which show us again nowhere close to reality, and not recognize that it is time to make some fundamental change in direction.

I think we have dug such a deep hole for this country, it will take a very big chunk of our lifetimes digging out. And, when you guys come in here, we get the same old song.

When are we going to be honest with each other and honest with the American people about what has to be done? We have got to cut spending, we have got to say to our allies it is time for them to start paying their fair share of their defense.

There was an interesting quote yesterday in the Post from the Secretary of the French Parliament's National Defense Committee. He said, "Do you think 320 million Europeans can continue forever to ask 240 million Americans to defend us against 280 million Soviets?"

They have figured out the answer to that in Europe. I do not know how long it will be before we figure it out here. But it is going to have to be soon, because what we are doing is not working, and it is clear that it is not working.

We have got to do the same thing on the revenue side. There is a new study out that shows if we had the 1977 audit rates effective in 1985, we would have collected $47 billion more in revenue—$47 billion more in revenue if we had the 1977 audit rates effective in 1985.

Now, I do not know what it is going to take to get the administration to admit that we are going to have to do a whole lot more than budget reform. We need results, not just reform. When are we going to have the administration come in and say it is going to take a whole lot more than what we have done?

Dr. MILLER. Senator Conrad, could I respond to you? You must have been out of the room, and I apologize I did not repeat it, but I did not bring any numbers up here. These are CBO numbers. So do not direct that at me, please. Secondly, I have not backed away from——

Senator CONRAD. Well, do you not accept them? Do you question them? Do you say these numbers are fundamentally flawed? Are they wrong?

Dr. MILLER. I have said that we do not have our numbers yet. We do not know whether those numbers are the correct numbers.

EXACT NUMBERS NOT AVAILABLE BY OMB YET

Senator CONRAD. Well, do you think that they are in the ball park, or do you think that they are totally off-base?

Dr. MILLER. Well, as I indicated, I think certain of those numbers appear to be in the ball park, and I have question marks about the others. It is no criticism. It is just that we do not have our numbers yet. And that was the understanding that I had with the committee before I came up, that I simply do not have numbers, and I apologize, but we go through a very long and involved process to come up with those numbers.

I have not, on behalf of the administration, backed away one iota from deficit reduction, and surely you do not believe with the President's going out and making the speeches that he has and giving the emphasis to the issue, that he has backed away from deficit reduction.

Senator CONRAD. Well, I do not think he ever put forth a credible plan for deficit reduction. We have had 6 years of speeches and no results. Now, that is enough speeches. How about some results?

When you say you do not have numbers, I read in the paper this weekend that within the administration it is believed that the deficit in fiscal 1988 is going to be $150 billion with what is on the table now. Is that not true?

Dr. MILLER. Well, I do not know what you are referring to. I mean, it could have been any piece of paper——

Senator CONRAD. Didn't the President ask for $12 or $15 billion of additional spending cuts? Didn't he send out communications to executive branch agencies saying we need to cut an additional $12

to $15 billion because the deficit has gone beyond what we anticipated?

Dr. MILLER. Well, at his direction I sent out a memorandum which asked for agencies to come up with additional—and we did not ask a specific number, but I think it was a ball park number that Marlin Fitzwater——

Senator CONRAD. On what basis did you send out that communication?

Dr. MILLER. Well, again you were not here, perhaps, but I discussed the fact that there has been some deterioration in economic performance as opposed to what we had assumed, and there has been some drifting up in the baseline deficit for fiscal year 1988.

Senator CONRAD. So you must have numbers that tell you that.

Dr. MILLER. Well, look, we have lots of numbers. You ask me for a number, and I can give you a lot of numbers. But I do not want to suggest that those numbers are official forecasts, or that they have been scrubbed, or that they are reflective of the Admistration's final forecasts. As I indicated, I have come up to Congress, although not necessarily before this committee. But I have on a number of occasions been as responsive as I could to Members of Congress asking ball park figures, and I have given them estimates. But some of the people who report those numbers, not Members of the Congress, have attached to them a significance that was unintended. They have not put the caveat down that it was a back-of-the-envelope initial forecast—hardly more than a guess. And for that reason, I do not want to come up and suggest that we have numbers, because we do not.

We go through a long, involved process with the agencies of finding out what the current services numbers will be, and that process is under way. As I indicated, we need to incorporate the effects of the supplemental bill that the President just signed. Reluctantly, we need to incorporate the rebasing of the gross national product. We need to incorporate the second quarter numbers on economic growth. There are a lot of things that we need to do, and we just do not have those numbers yet. And again——

Senator CONRAD. I find that very hard to believe, that you have sent out a communication saying make cuts, based on no numbers.

Dr. MILLER. We know that the number is higher, that the deficit number is higher than $108 billion, as I indicated earlier. But we do not know precisely what the number is.

Chairman CHILES. Senator Gramm?

RECONSTITUTE GRAMM-RUDMAN-HOLLINGS LAW

Senator GRAMM. Mr. Chairman, first let me say that I think this whole debate is living proof of why we need to reconstitute the Gramm-Rudman-Hollings law. It is clear that there are a lot of programs that could be cut that have not been cut. It is clear that there are people up here talking about taxes when we know the President is not going to sign a tax bill. The distinguished Director of OMB has outlined a few wasteful programs, two of which are in a bill the President just signed into law.

Dr. MILLER. He had to.

Senator GRAMM. I submit that, had Gramm-Rudman-Hollings automatic triggers been in effect, the President would have found that he did not have to sign the supplemental appropriations bill. He would have found that he could say to Congress, "Either you fix CCC, and do not include all this add-on spending, or else I am going to veto it," and miraculously, we would have complied.

The problem is that we do not have binding fiscal constraints; therefore both parties can shout at each other that they have the solution while neither one of them is forced to actually materialize it. When you get to the bottom line with revenues having grown in this miraculous recovery we have had, the reason the deficit is growing is that spending has grown faster than revenues.

Revenues exploded in 1983 and 1984 and 1985, but so did spending. And every one of those spending bills was passed by Congress, and every one was signed by the President.

Without binding constraints, the job is just not going to get done.

OMB CRITICAL OF DEFICIT TARGET APPROACH

I would like to ask one question, Mr. Miller, and that question is this: What do you think of a deficit target which would simply take the CBO baseline, or an average of OMB/CBO baselines, or whatever baseline you want to put out front; you set out that baseline at the beginning of the process, and then you say your target is to reduce that baseline's deficit by $36 billion, rather than having the kind of fixed deficit targets we have had in the past?

What do you think of that approach? Do you like it; do you dislike it; what are the pitfalls we ought to look at in terms of trying to assess the viability of that approach?

Dr. MILLER. Let me say first of all, I am critical of it for at least three reasons. One is I think it is not nearly so easy to understand, or for the American public to hold Congressmen and Senators accountable.

Secondly, it increases by several magnitudes the opportunities for any estimator to engage in gamesmanship—and I am sure the Acting Director of CBO would share my concerns about what would be inordinate pressures and suggestions made to change the baseline or the current services number to accommodate.

Thirdly, depending on how it worked, it would not assure that we would have a steady, monotonic decline in that deficit figure; it would not assure that we would reach zero deficit by 1991, 1992, or whatever.

Finally, fourthly let me say that depending on the circumstance, it could arguably work against what we all want to accomplish, and that is to reduce the deficit with minimum total pain over the period of 5 years where we get the deficit down to zero. You might, for example, have in 1 year a baseline deficit that under one estimate is much higher than for the preceding year, and what do you do then? Do you base it on the baseline estimate for the current year? Do you base it on the baseline estimate for the previous year? Do you base it on the estimate of the real deficit for the previous year?

It depends on how it is written. Chairman Rostenkowski has a proposal, I understand, and Mr. Chairman, you are looking at a

similar proposal. I would just have to look at the details. But I think it would be easier to look at this downward slope.

OFFSET SAVINGS FOR 1989

Could I make one observation, and this is just a personal observation here that you might want to consider doing something about, and that is in terms of those targets, you might want to figure out a way that you might be able to save 1 year for the next, the reason being that it looks like, for example, it is going to be reasonably easy to accomplish deficit reduction this year, but not quite so easy as last year, that is, from 1986 to 1987. We can accomplish from 1987 to 1988 some deficit reduction; if we all work hard and hold tight, I think we can do it.

But if you look at the numbers there—and again, our preliminary assessment is that it is in accord with that—it is going to be much, much more difficult for fiscal year 1989 if you have a continuing downward slope. You might want to be able to think about, at least, offsetting some savings from 1988 to 1989—that is, if the targets, say, were $150 billion, just to pick out the number—I know that there are different numbers being discussed—and you came to it at $140 billion, that would be $10 billion that could be applied to the deficit target for fiscal year 1989.

So you might want to consider something like that, because if I look at these things, and I look at the character of that line, I think the crunch is coming in 1989, not in 1988.

Chairman CHILES. Senator Grassley?

ESTIMATING REFORM NEEDED

Senator GRASSLEY. First of all, let me say that I am looking forward to helping to support some budget process reform; I have my name on several such proposals; I think the point you just made, Mr. Miller, about the bias of estimators to be maybe more irresponsible under the proposal just suggested, would lead me to a crucial point—it is almost so bad that there is hardly a budget reform proposal I do not like in the sense of helping move the process along—but is it really budget process reform that is really the problem here, or isn't it a little more specific, that what we need is estimating reform? It seems to me like——[Laughter.]

Yes, I said this during the hearings we had last winter. I had an amendment to this effect that passed and then was taken out during budget mark-up that would have us estimate after the fact so that the estimating process would compensate for bias and rosy scenarios in the budget process by having after-the-fact estimating.

So, I do not know what the laughter was for, but I want to suggest to you——

Senator DOMENICI. I was saying it is a great idea if we could figure out how to do it; that was my reason for laughing.

Senator GRASSLEY. Okay. But anyway, you have been underestimating, Mr. Miller, just like CBO has been, for a long period of time. What are you doing to see that we get more accurate estimating—or can you say that it is an impossibility; that you just cannot do anything about it? If you told me that, I guess I would say

thank God for somebody who is candid, but everybody says we can do more about it, Mr. Miller. So, from your perspective——

Dr. MILLER. Senator Grassley, I am not going to answer that there is nothing to be done about it, but I am also going to be candid with you.

It is very difficult to make these estimates and to be accurate every time. That is what a projection or estimate is. It is a best approximation of something that is going to happen in the future, and we do not know what is going to happen in the future.

OMB AND CBO ESTIMATES CLOSE TO INDEPENDENT FORECASTERS

If you will look at the studies that have been made, you will find that OMB, in fact, and CBO have both been in the ball park of independent forecasters. I direct your attention to the lead letter to the editor in today's Wall Street Journal on that point.

What we find, of course, is that different estimators at different points in time are very, very accurate. If you look at who has made the best forecast from one year to the next, one person will be up at the top one year and be down toward the bottom the next year. We have been reasonably close. Both CBO and OMB have been within a range of reasonableness with the private forecasters.

Sometimes we underestimate growth. We did that in 1984, for example. The last couple of years, we have overestimated growth, but not outside the bounds of reasonableness.

Keep in mind that what is characterized as the rosy scenario comes mainly from the assumptions about economic growth. But what drives the revenue figures is nominal GNP, and that is a product of both growth and inflation. And if you look at those two figures together, our estimates of nominal GNP have been very much in accord with the estimates of, say, blue chip.

Senator GRASSLEY. Well, you suggested 1 year, and I will give you that. But there has been consistent underestimating of the budget. Now, I can understand how difficult it is——

Dr. MILLER. Senator, that is just wrong. We estimated the budget deficit for fiscal year 1987 at $173 billion, including rescissions and deferrals which we did not get; that made it $175 billion. And the deficit this year, Senator Grassley—put the money in your pocket—will come in lower than that figure—lower.

Senator GRASSLEY. Yes, well, remember, though, that that was due to changes in the tax bill, and everybody——

Dr. MILLER. Our estimate of the budget deficit assumed the changes in the tax bill.

Senator GRASSLEY. Well, it is a one-time deal. You are well aware of the county fairs and greased pig contests. A pig is difficult enough to catch without greasing him. And it just seems to me like we are pouring more grease on this process all the time, just making these budget deficit estimates more elusive all the time.

Dr. MILLER. We threw a tub of detergent in there. We are going to clean that pig off and make him easier to catch. I think if you will look at the assumptions that we have for last January and also the revisions that we have for the mid-session review, I do not think they can be really criticized very much.

EXCLUDING ASSET SALES WOULD BE A MISTAKE

Chairman CHILES. One of the things we are talking about is providing, in addition to a glide path that needs to be changed, that we must make at least $36 billion in policy deficit reduction per year. Given the fact that in the last 2 years combined, that we have not achieved $36 billion in policy reductions off the deficit, what do you think about a proposal like that?

Dr. MILLER. Mr. Chairman, could I have a qualification. Do you mean by policy changes, you would exclude asset sales?

Chairman CHILES. Yes.

Dr. MILLER. Would you exclude also user charges?

Chairman CHILES. No—nonrecurring provision.

Dr. MILLER. I see. I would argue against that. Let me say first of all, I think credit reform, which involves among other things sale of monetary assets——

Chairman CHILES. Well, that depends on whose credit reform you are talking about.

Dr. MILLER. Well, the President's credit reform—but also privatization—both of those things stand on their own feet. They are good public interest proposals that if we had a balanced budget, I would still be advocating, and I think many other people would be, too. It is better government to do that.

But I think probably during this transition period, from the time we have high deficits—less than in 1986—until we get a balanced budget, I think it would be a mistake to exclude asset sales from those calculations. And one reason is I think we can get there and maintain economic growth and get out there and balance the budget without as great a difficulty as would be the case if you did not allow those asset sales.

And let me just say one other point, and a related point, and that is I am suspicious that without asset sales, without the opportunity for asset sales, there would be much, much greater pressure to increase taxes. And this is something I know this President does not want and something I believe the American people would not want.

Chairman CHILES. Thank you very much, Mr. Miller.

Dr. MILLER. Thank you, Mr. Chairman. I hope we can get together. I am at your disposal. I will keep my 4-hour slot open. I hope that I can meet with you and Senator Domenici and anyone else that you would like and that we can work on budget process reform and Gramm-Rudman-Hollings fix.

Chairman CHILES. We like that. We wish you would extend that table a little bit further and put everything on it.

Dr. MILLER. I shall be there in your office any time you like. Thank you.

Chairman CHILES. Now, we will hear from the Congressional Budget Office. Before we begin, I want to take a minute to extend a special welcome to Dr. Gramlich, the Acting Director of the Congressional Budget Office. This is your first appearance before the Senate Budget Committee. You are widely known as a distinguished economist from the University of Michigan. You have moved into a difficult job during difficult times, and thus far I can

say your performance is right in line with the caliber of top professionals that have come before you.

The Budget Act has a provision that says if the Director steps down, his chief deputy moves up to his job. It is fitting that since one of our topics today will be automatic sequester, Dr. Gramlich is the first automatic Director.

So welcome, Doctor. We are glad to have you with us.

Senator DOMENICI. Doctor, I note that you are so "acting" that you had to bring your own name plate. If we leave you "acting" long enough, maybe we will make one for you.

STATEMENT OF DR. EDWARD M. GRAMLICH, ACTING DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. GRAMLICH. Thank you very much, Mr. Chairman and Senator.

I appreciate the opportunity to testify on our preliminary estimates. I should stress that these are very early numbers. The CBO would not normally be making estimates public at this time, but we are doing so this year at the request of the chairman and the ranking member of the committee. The figures are very preliminary and may change somewhat before we complete our summer update report and our sequestration report in mid-August.

Moreover, the estimates were prepared without the benefit of the Department of Agriculture's first crop survey for the growing season, and they also do not reflect the data on the GNP for the second quarter of the year, which will be released on July 24th.

Let me move right into my statement. It's about five pages; I am going to try to read it quickly, and you can follow with the tables that I will refer to. I am going to read most of it, because I think it is all important.

Table 1 shows our preliminary summer estimates of baseline outlays, revenues, and the deficit and compares them with CBO's winter baseline.

TABLE 1. PRELIMINARY REESTIMATES OF CBO BASELINE (By fiscal year, in billions of dollars)

	1987	1988	1989	1990	1991	1992
Outlays						
Winter baseline	1,010	1,071	1,126	1,188	1,248	1,306
Preliminary reestimates	3	7	25	30	38	46
Preliminary baseline	1,013	1,078	1,152	1,218	1,286	1,352
Revenues						
Winter baseline	834	900	962	1,051	1,139	1,222
Preliminary reestimates	18	-4	-8	-17	-26	-30
Preliminary baseline	852	897	954	1,034	1,113	1,192
Deficit						
Winter baseline	176	171	164	137	109	84
Preliminary reestimates	-15	11	33	47	64	76
Preliminary baseline	161	181	198	183	173	160

BASELINE BUDGET PROJECTIONS

While our winter baseline deficit projection declined steadily from $176 billion to $84 billion by 1992, the new estimates show a different pattern. Because of unexpectedly strong revenue growth, the 1987 deficit is now estimated to be $161 billion. The deficit then rises to $181 billion in 1988 and $198 billion in 1989, as has been noted previously.

This puzzling pattern of deficits is caused largely by the phase-in of the Tax Reform Act and by various one-time outlay reductions, as shown in Table 2.

TABLE 2. EFFECT OF TAX REFORM AND ONE-TIME OUTLAY SAVINGS ON DEFICIT (By fiscal year)

	1987	1988	1989	1990	1991	1992
			In Billions of Dollars			
Preliminary Baseline Deficit	161	181	198	183	173	160
Adjustment for:						
Tax reform	18	-13	-17	-4	2	-1
One-time outlay savings a/	16	3	-2	-1	-1	-1
Total adjustments	34	-10	-19	-5	1	-2
Adjusted Deficit	194	171	179	178	174	157
			As a Percent of GNP			
Preliminary Baseline Deficit	3.7	3.9	4.0	3.4	3.0	2.6
Adjusted Deficit	4.4	3.7	3.6	3.3	3.0	2.6

a. Includes asset sales, loan prepayments, OCS escrow releases, military pay delay, Medicare payment delay, and advance of final revenue sharing payment.

Tax reform, if you look at that row, has added about $18 billion to revenues in 1987, and then it reduces revenues $13 billion and $17 billion in the next 2 years. Asset sales, loan prepayments, the 1-day delay of the military pay date, and other one-time outlay reductions total $16 billion in 1987 and $3 billion in 1988. Removing these two items yields an adjusted deficit that averages about $175 billion over the next 4 fiscal years.

These adjusted deficits do decline relative to GNP—shown in the bottom row of the table—from 4.4 percent of GNP in 1987 down to 2.6 percent in 1992. But this is a much slower decline than we have had previously.

Table 3 reports the changes to the baseline budget projections since our last report. The most significant changes stem from revisions to our economic projections. The supplemental appropriations bill, which allows prepayment of additional REA loans without penalty lowers 1988 outlays. Technical reestimates resulting primarily from new data on taxable incomes, raise revenues a bit in all years. I should add—and this is liable to get some discussion—

that our preliminary estimates also follow the recent GAO opinion in assuming that the thrift savings fund is not included in the budget totals. As a result, the thrift fund's receipt of voluntary employee contributions would no longer be treated as reducing the deficit, and agency contributions would add to the deficit by the amounts that you see in the table.

TABLE 3. DETAIL OF PRELIMINARY BASELINE REESTIMATES (By fiscal year, in billions of dollars)

	1987	1988	1989	1990	1991	1992
Outlays						
Enacted Legislation	2	-7	1	1	0	0
Economic Reestimates						
Interest rates	1	11	13	13	15	17
Cost-of-living adjustments	0	1	4	6	9	10
Discretionary inflation adjustments	--	0	1	1	1	1
Other	-1	-1	0	0	0	0
Subtotal	0	11	18	21	25	28
Technical Reestimates	0	1	2	1	2	3
Debt Service	0	-1	1	3	7	11
Thrift Fund Accounting	1	3	3	3	3	3
Total	3	7	25	30	38	46
Revenues						
Economic Reestimates	-8	-13	-17	-25	-32	-38
Technical Reestimates	26	9	9	8	6	8
Total	18	-4	-8	-17	-26	-30
Deficit						
Enacted Legislation	2	-7	1	1	0	0
Economic Reestimates	8	24	35	46	57	66
Technical Reestimates	-26	-9	-6	-7	-4	-5
Debt Service	0	-1	1	3	7	11
Thrift Fund Accounting	1	3	3	3	3	3
Total	-15	11	33	47	64	76

ECONOMIC PROJECTIONS

Let me turn to the economic projections. The major differences between our revised economic projections and those in our January report are higher inflation and interest rates for 1987 and 1988 and lower real economic growth in all years. Table 4 summarizes these preliminary economic assumptions and compares them with what we had in January.

TABLE 4. COMPARISON OF CBO WINTER ECONOMIC PROJECTIONS AND PRELIMINARY SUMMER PROJECTIONS (By calendar year)

	Actual	Forecast		Projected			
	1986	1987	1988	1989	1990	1991	1992
GNP (billions of current dollars)							
Summer	4,206	4,447	4,753	5,075	5,425	5,800	6,200
Winter	4,216	4,469	4,779	5,124	5,503	5,888	6,288
Real GNP Growth (percent change)							
Summer	2.5	2.5	2.5	2.5	2.6	2.6	2.6
Winter	2.6	2.8	3.0	3.0	3.1	2.7	2.5
CPI-W (percent change)							
Summer	1.6	3.8	5.6	5.0	4.5	4.5	4.6
Winter	1.6	3.5	4.3	4.3	4.3	4.3	4.3
Three-month Treasury Bill Rate (percent)							
Summer	6.0	6.1	6.6	5.9	5.9	5.9	5.9
Winter	6.0	5.6	5.7	5.6	5.5	5.3	5.2
Ten-Year Government Bond Rate (percent)							
Summer	7.7	8.4	8.7	7.6	7.2	6.8	6.4
Winter	7.7	7.2	7.2	6.6	6.2	5.9	5.6

Consumer price inflation is higher than before for two reasons. One is that oil prices have risen much more this spring than we expected, and the second is that the dollar has fallen much more than we expected.

The oil price increase has already shown up at the gasoline pump and elsewhere, but the lower dollar will continue to raise the cost of imported goods and other consumer purchases through the end of 1988. Because of the current amount of slack in the economy, however, we do not expect these price increases to touch off a wage-price explosion such as happened in the 1970s. We assume, therefore, that the increase in inflation will be temporary.

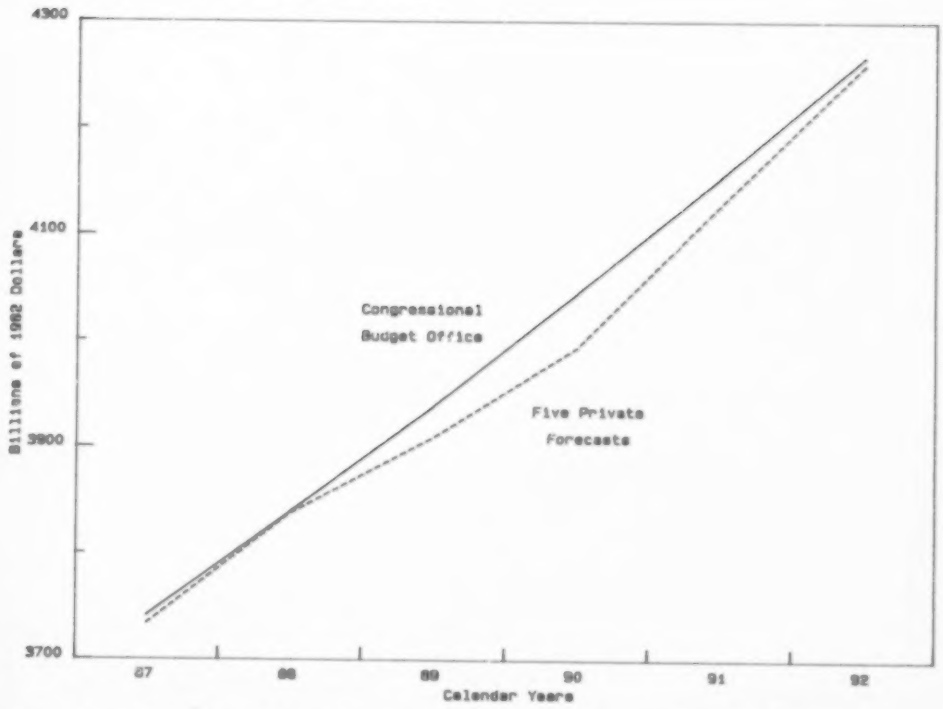
Interest rates in our preliminary forecast are also higher than we assumed in January. In large part, this rise is a reflection of increases in interest rates that have already taken place. We expect that higher interest rates will persist through the end of 1988, both because of higher inflation and because of the Federal Reserve's announced intention to lean against further declines in the dollar.

The reduction in the real GNP growth forecast for 1987 and 1988 results from the higher interest rates and the adverse effect of higher inflation on household real incomes. The change in the growth assumptions after 1988 arises from a reappraisal of the long-run growth prospects of the economy which CBO initiated late last year. Our analysis has also benefited from new long-run labor force projections recently released by the BLS.

The revised long-run growth path assumes that, after adjusting for cyclical changes, growth of gross domestic product will exceed growth of the labor force by about 1 percentage point—the same amount as in the 1981–87 period. Nonfarm productivity, as conventionally measured, grows by close to 1.5 percent per year. In addition, CBO assumes that by 1992 the economy will reach an average operating rate—that is, a level somewhat below its full capacity and averaged over a historical period.

The level of real GDP that we project as a result of all of these assumptions is still very slightly above the average of five private forecasts, which we also show in figure 1.

Figure 1.
Projected Real Gross Domestic Product



NOTE: The private forecasts are Chase Econometrics, Data Resources, Townsend-Greenspan, Wharton Econometric Forecasting Associates, and Washington University (St. Louis).

We have not seen any new information that would call for significant changes in this preliminary economic forecast, which we developed in mid-June. We are, however, particularly concerned about movements in prices, the exchange rate, and interest rates, which have already changed a little bit. Many private forecasters expect lower consumer price inflation for 1987 and 1988 than is in our preliminary forecast, apparently because they expect smaller increases in import prices.

Interest rates have also fallen a little since mid-June, and this drop will probably lower our short-term interest rate projections by a few tenths of a percentage point in August if it is maintained. But I should emphasize that interest rates are bouncing around a lot lately.

I should also emphasize that small changes in these assumptions may have a large effect on the budget. In particular, as the Federal debt has grown rapidly during the 1980s, outlays have become increasingly sensitive to both the level and the term structure of interest rates. We show in table 5, that a change of 1 percentage point in all government interest rates would affect net interest outlays by amounts growing from $5 billion in 1988 to $25 billion in 1992. And even if short-term interest rates could be projected exactly, which is obviously a Herculean assumption, a 1-percentage-point change in medium- and long-term rates would still change outlays substantially.

TABLE 5. EFFECTS ON CBO BASELINE BUDGET PROJECTIONS OF SELECTED CHANGES IN ECONOMIC ASSUMPTIONS (By fiscal year, in billions of dollars)

	1988	1989	1990	1991	1992
Interest Rates					
Effect on Net Interest Outlays of a One-Percentage-Point Change in All Interest Rates Beginning October 1987	5	11	16	20	25
Effect on Net Interest Outlays of a One-Percentage-Point Change in Medium- and Long-Term Rates Beginning October 1987	2	6	10	14	17
Consumer Prices					
Effect of a 0.5 Percentage-Point Change in Cost-of-Living Adjustments in January 1989 and 1990	0	1	3	4	4

EFFECTS OF REESTIMATES

Finally, let me make one more point. I will just report the effects of our reestimates on the recently adopted Congressional Budget Resolution for fiscal 1988. Under CBO's winter assumptions, the policies of the budget resolution would have resulted in deficits of $134 billion in 1988, $115 billion in 1989, and $72 billion in 1990. Under the new economic and technical assumptions, the deficit figures would be $151 billion in 1988, $147 billion in 1989, and $117 billion in 1990. These figures are all in table 6.

TABLE 6. PRELIMINARY REESTIMATES OF CONGRESSIONAL BUDGET RESOLUTION (By fiscal year, in billions of dollars)

	1988	1989	1990
Budget Resolution Deficit under CBO Winter Assumptions	134	115	72
Preliminary CBO Reestimates			
Economic reestimates	24	34	45
Technical reestimates	-9	-6	-7
Debt service	-1	1	4
Thrift fund accounting	3	3	3
Total reestimates	17	32	45
Preliminary Reestimate of Budget Resolution Deficit	151	147	117

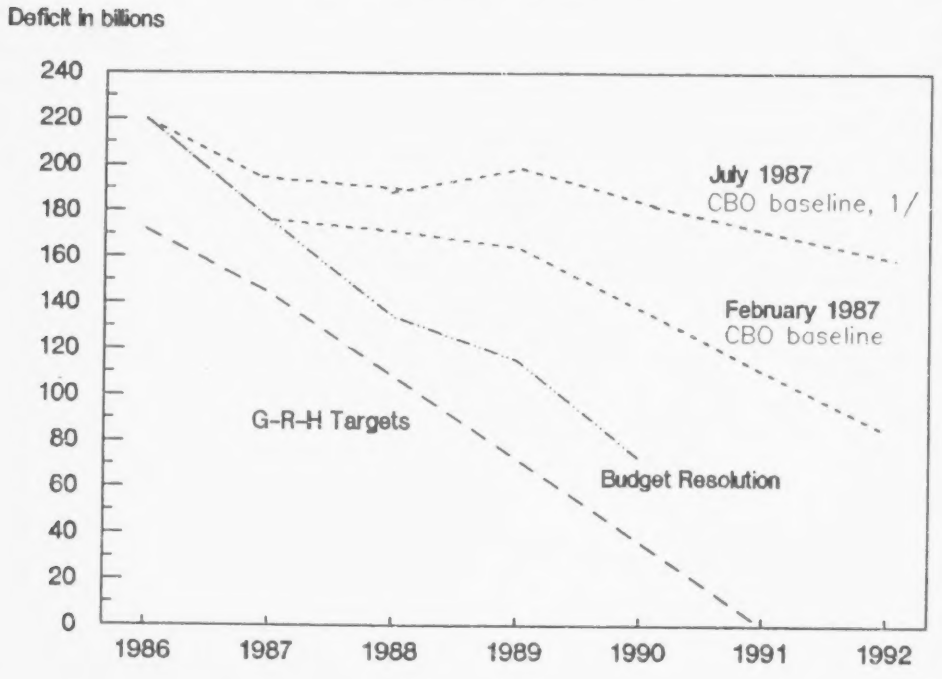
The reestimates reflect mainly the revised economic assumptions discussed previously. I should also say that recently enacted legislation does not affect the budget resolution estimates because most of the items included in the supplemental appropriation, including the REA prepayments, were already assumed in the resolution. An additional $30 billion in deficit reduction measures called for by the budget resolution, however, do remain to be enacted.

Thank you very much, Mr. Chairman, and now I am open for questions.

Chairman CHILES. Thank you.

What you are saying, it seems to me, is that if we do nothing, the deficit in 1988 is going to jump to $187 billion, whereas in March you estimated that deficit would be $171 billion.

CBO Deficit Projections



1/ Adjusted for one time savings and revenue windfall in 1987

Prepared by Senate Budget Committee staff
July 13, 1987

Dr. GRAMLICH. In 1988, I think it is $181 billion.

Chairman CHILES. Well, $181 billion is taking out the REA refinancing that went into the Budget Act. So without that, it would be $187 billion, would it not?

Dr. GRAMLICH. Yes, right.

Chairman CHILES. And you have said that is primarily because of interest rate increases and inflation increases. Is that also some declining revenues?

Dr. GRAMLICH. Yes; if you look at table 3, you can see the list of things there. The economic reestimates are $24 billion, which is obviously the major part. Much of that is on the revenue side, because of the less optimistic economic forecast.

Chairman CHILES. Less optimistic economic forecast. All right.

COST OF DEBT RISES WITH INTEREST RATES

Well, you have also said—and we know CBO has recently increased its estimates of what the interest rates are going to be—with our national debt so huge, doesn't the cost of carrying that debt really go up when interest rates rise? Can you give us an idea of what the sensitivity of the deficit is to an increase in interest rates?

Dr. GRAMLICH. You are onto a very important point, which is that we can attack the estimators all we want here, but one of the

problems that we are stuck with as a result of the rapid growth in debt is that the deficit estimates become very susceptible to things that nobody can predict very well.

Bond traders who are making a lot more than any of us have trouble getting these estimates correct. But in any case, the numbers are in table 5, and they give some impression of what happens if you miss the overall level of interest rates—that is in the first row. The second row is simply the effect of medium- and long-term interest rates, where expectations play a much bigger role, and which are pretty hard to nail down. So even if you get short-term rates right, you still are open to lots of estimating discrepancies.

Chairman CHILES. So you are showing that the effect of a 1-percentage-point change in interest rates is $5 billion in 1988, $11 billion in 1989, and $16 billion in 1990, and $20 billion in 1991.

Dr. GRAMLICH. Right; it builds up.

Chairman CHILES. And $25 billion in 1992. And that is the short-term rate. The other is the medium- and long-term rates would be from $2 billion in 1988, to $6 billion in 1989, $10 billion in 1990, $14 billion in 1991, and $17 billion in 1992.

Dr. GRAMLICH. Right. And all of those numbers are much higher than they used to be a few years ago.

Chairman CHILES. Well, that might be one reason that we want to look at whether or not to bind ourselves to fixed targets, because those rates can change on us any time and leave us trapped by those fixed targets.

THE DEFICIT WITHOUT SOCIAL SECURITY SURPLUSES

Your baseline deficit of $187 billion in 1988 includes both social security revenues and outlays. The official on-budget deficit figures must exclude social security, which is now legally off-budget, but social security is running even larger surpluses each year; by 1992, the surplus will be about $75 billion, and it keeps growing from there.

What would the 1988 deficit be without the social security surplus? Isn't it true that according to your estimates, the on-budget deficit would be over $200 billion a year through 1990 if we did not have these surpluses?

Dr. GRAMLICH. Yes, I think the presumption in your question is about right. We simply have not had a chance to do that split, and we would prefer to supply those numbers later.

[The following was subsequently supplied for the record by CBO:]

CBO BASELINE PROJECTIONS

The following table shows CBO baseline projections for on-budget and off-budget revenues, outlays, and the deficit (by fiscal year, in billions of dollars).

	1987	1988	1989	1990	1991	1992
Total (including social security):						
Revenues	852	897	954	1,034	1,113	1,192
Outlays	1,013	1,078	1,152	1,218	1,286	1,352
Deficit	161	181	198	183	173	160
On-budget (excluding social security):						
Revenues	639	658	695	752	807	866
Outlays	819	874	934	986	1,040	1,089

	1987	1988	1989	1990	1991	1992
Deficit	180	216	240	234	233	223
Off-budget (social security):						
Revenues	214	239	259	283	306	326
Outlays	194	204	217	232	247	263
Surplus	19	35	42	51	59	63

Chairman CHILES. Just months ago, we were told that deficit reduction in the out-years would be easier than previously thought. CBO told us in the absence of any Congressional action, if we did nothing to enact policies to reduce the Federal deficit, the deficit would start declining anyway. CBO's forecast showed that as we moved further into the out-years, the deficit picture would improve even more, whether or not we enacted deficit reduction policies.

PROJECTED DECLINE HAS TAKEN TURN UPWARD

Many of us were skeptical at that time that this projected decline would ever pan out, and now your own data bears this out. Your new forecast shows the baseline deficit increasing from $187 billion in 1988—or $181 billion, if you take the REA money out—to $198 billion in 1989, making deficit reduction efforts even harder. In other words, the tables have turned. If Congress does nothing, the deficit will climb.

What is the cause of this reversal from the previous downward trend?

Dr. GRAMLICH. There are several causes. The rise in interest rates has certainly been a very strong factor, as we just discussed. We have lowered the short-run economic forecast almost continually since that happened. Those optimistic numbers you are referring to were generated in the winter of 1986. While we have been very fortunate since then in avoiding recession, the expansion has not really grown to the level that we assumed at that time.

Also, we have since that time gotten a lot of disconcerting evidence on productivity growth, and in the long run productivity growth becomes a very important factor, perhaps the most important factor, in the long-run deficit path.

We now are less optimistic on the long-run productivity of the economy and the implicit growth in revenues. But one thing I would point out just in the interest of full disclosure is that we put table 2 in the testimony for a reason. We figured there would be a lot of attention to the deficit growing from $161 billion to $198 billion, and we wanted to show that that increase is largely a result of the tax bill and of the one-time outlay savings. Perhaps a better measure of what is really going on is this adjusted deficit, which seems to be stuck in the mid-1970s for the 4 years from 1988 to 1991. Now, that is not great news, because previously we would have thought that even the adjusted deficit would be declining. But it is perhaps not quite as bad as it seems, because a lot of the immediate increases result from other factors, which are, in your words, nonrecurring.

CBO'S NEW ESTIMATE OF PRESIDENT'S BUDGET

Chairman CHILES. Last February, CBO reestimated the President's budget and found that in 1988 the deficit would be about $134 billion, not the $108 billion as the President had projected. Based on your revised baseline which you have been discussing with us today, could you tell us what CBO's new estimate of the President's budget deficit is, assuming the policies included in his January budget request? I will ask you not to count the $5 billion you estimate as savings from REA loan repayments since they were not in the President's call for these savings in his original budget.

Dr. GRAMLICH. That is the proper way to ask the question, and here I will refer you to table 3. If you look down at the bottom of the table, you will see that we had an $11 billion increase. If you do not count that REA change, that number goes to $16 billion, so the $134 billion number that we had in January goes to $150 billion.

Chairman CHILES. To $150 billion. And have you priced the——

Dr. GRAMLICH. To say that another way—since this is likely to become a matter of some discussion—in the bottom panel of table 3, the economic reestimates stay, the technical reestimates stay, with one exception which I will mention in a second; the debt service stays, and the thrift fund accounting stays.

For technical reestimates, the figure is a little confusing because it includes a reestimate of the impact of the REA refinancing. If you take that out, the enacted legislation should really be a minus-five. All of the other things count to raise the $134 billion, and that now goes to $150 billion. In other words, we upgrade it by the economic reestimates, the technical reestimates, et cetera, and you get to about $150 billion.

TARGETS EXCEEDED BY SUBSTANTIAL AMOUNT

Chairman CHILES. All right. One of the major difficulties we have had this year in restoring the Gramm-Rudman-Hollings glide path towards a balanced budget is the fact that the actual deficits in 1986 and 1987 have exceeded the targets by a substantial amount. Can you tell me how much the targets were missed and why the targets were missed by such a large amount?

Dr. GRAMLICH. Well, I can, if you want to—I have two options here. I can leaf through this big book here and find it, or I could supply it later. We have those numbers. I just do not remember them.

Senator DOMENICI. Which years are you asking about, Mr. Chairman?

Chairman CHILES. 1986 and 1987.

Dr. GRAMLICH. Why don't I supply that later? I could find it, but it would take a few minutes.

[The following was subsequently supplied for the record by CBO:]

TARGET DIFFERENCES

The deficit in 1986 reached $220.7 billion—$48.8 billion above the budget resolution and Balanced Budget Act target of $171.9 billion. The current estimate of the 1987 deficit is $161 billion—$18 billion over the budget resolution figure of $143 billion and $17 billion over the Balanced Budget Act target. The following table shows

the sources of difference between the actual deficit totals (for 1987, the current estimate) and the budget resolution estimates (in billions of dollars).

	1986	1987
Policy assumptions	15.7	−13
Economic assumptions	10.9	18
Technical assumptions	22.2	13
Total differences	48.8	18

Chairman CHILES. All right. I yield at this point.

Senator DOMENICI. Can you look up there at that chart, which has been put together by my staff after consulting with your people at CBO.

Current Law Gramm-Rudman-Hollings Targets vs. Baseline Estimates

($ billions)

Fiscal Year	Current G-R-H Targets	Baseline Deficit Estimates CBO Feb. '87	CBO July '87
1986	172	221 a/	- - -
1987	144	176	161
1988	108	171	179
1989	72	164	198
1990	36	137	184
1991	0	110	173
1992	0	85	160

a/ Actual FY 1986 Deficit

Prepared by Republican Staff,
Senate Budget Committee.

Dr. GRAMLICH. Right.

Senator DOMENICI. The 1987 target was $144 billion; we had a $10 billion leeway to $154 billion. The CBO baseline estimate in February was $176 billion. Is it fair to say that your estimate now, the July estimate, is $161 billion, as I have it there on the chart?

Dr. GRAMLICH. Yes.

Senator DOMENICI. So in that year, regardless of whether one likes the mix or dislikes the mix, we missed the $154 target by $7 billion.

Dr. GRAMLICH. Right.

TAX BILL AND ECONOMY CAUSE TARGET CHANGES

Senator DOMENICI. Now, looking at that next line, 1988, your baseline deficit in February 1987 was $171 billion. Now, some of the Senators here, when we start talking about new targets, immediately ask the question why did the deficit rise to $171 billion when it was $161 billion the year before. That is my first question. And now you are saying that as a matter of fact, your July reestimate will be not $171 billion for fiscal year 1988, which is where Congress started its work to get to a $134 billion deficit, but rather, $179 or $181 billion. Is that correct? But what happened between 1987 and 1988, and why does $171 billion rise to $179 billion? Without going through your book, what are the principal reasons for the change?

Dr. GRAMLICH. Well, let us talk about the increase from $161 billion to $171 billion first.

Senator DOMENICI. Please.

Dr. GRAMLICH. The way you said it, it sounds like one step, but I like to think of it in two steps. Actually, the earlier estimates were to go from $176 billion in 1987 to $171 billion in 1988. There was always kind of a plateau in the deficit because of the tax bill, but the impact of the tax bill seems to have gotten more dramatic since we looked at it last. Because of that and other technical reestimates on the revenue side, the deficit estimate for 1987 goes down to $161 billion.

That is one thing that has happened. The other is that the economy has not been as strong this year as we thought it would be even in January. Interest rates are higher, with all that implies, so we had to up the $171 billion figure for 1988 to $181 billion mainly because of economics.

Thus, the tax bill and the economic changes explain most of the change in the deficits.

Senator DOMENICI. Now, if we were to implement the current budget passed by the Congress—I am not suggesting that it will be; I am merely asking the question if we were we will not reach the deficit that that budget assumed because of the change in the baseline deficit estimate; is that correct?

Dr. GRAMLICH. Well, let us see——

Senator DOMENICI. How far off will the budget resolution be? Maybe that is a better way to ask it.

Dr. GRAMLICH. Well, I think it is more off than that.

Senator DOMENICI. It is; it is $13 billion off.

Dr. GRAMLICH. We estimate the current budget resolution now at $151 billion for 1988. That is in table 6.

Senator DOMENICI. And using the CBO February estimates, it was supposed to be what?

Dr. GRAMLICH. $134 billion—I read from table 6—It was what we projected back in the winter. It has now gone up to $151 billion, but I think you are comparing it with $108 billion. We got from $108 billion to $134 billion, by replacing the President's economic assumptions, something that was talked a lot about at the time; and the difference between $134 billion and $151 billion results from all of these new things that are explained in table 6.

Senator DOMENICI. How much of this is due to economic reestimates? Is it the largest piece?

Dr. GRAMLICH. That is right.

Senator DOMENICI. Technical reestimates are negative.

Dr. GRAMLICH. Right.

Senator DOMENICI. Debt service is up slightly.

Dr. GRAMLICH. Right.

Senator DOMENICI. And then there is the thrift fund accounting, which we still have to decide how to treat.

Dr. GRAMLICH. That is right.

APPROPRIATIONS EFFECT ON THE REESTIMATE

Senator DOMENICI. Are there any other things that affected the reestimate? I mean, we hear so much about appropriations. How much did it affect the reestimate; do you know?

Dr. GRAMLICH. Well, we are talking about 1988. I believe we have not had any appropriations yet.

Senator DOMENICI. Well, is the FY 1987 supplemental in there?

Dr. GRAMLICH. Yes.

Senator DOMENICI. Well, there is an effect of 1987 supplemental on 1988, which obviously——

Dr. GRAMLICH. The supplemental is in there, yes.

Senator DOMENICI. The supplemental is in there.

Do you have anything that would show us in the 1987 year how much of the excess over the $144 billion target was attributable to committees appropriating more than their targets in outlays?

Dr. GRAMLICH. We have that. I would prefer to supply that to you later. [Conferring with staff.] I understand that we do not have that yet. We will have that.

[The following was subsequently supplied for the record by CBO:]

EXCESSES IN APPROPRIATING

According to current estimates, defense outlays in fiscal year 1987 exceed the budget resolution target by $0.8 billion on account of higher appropriations. Nondefense discretionary appropriations are $1.8 billion higher. These figures may be revised in CBO's August report.

Senator DOMENICI. Based on your experience, can you give us some kind of a ball park figure? I think it is very important that as we move to these new targets that we have some understanding of why the final estimate turns out to be substantially off the previous estimate. We are currently engaged in a discussion which Senator Gramm has just raised with Director Miller about fixed deficit targets versus something like $36 billion off a fixed estimate. And we need to know, if the estimates are going to be substantially off, who is to blame, or were they unavoidable errors, or was it due to estimating errors.

Can you give us some help on that?

Dr. GRAMLICH. I can give you some help on that. In our August report which is currently in various drafts, we are planning to go through a fairly extensive analysis of why the actual budget deficit, as Senator Grassley said earlier, was higher than it was in the Congressional Budget Resolution. We are looking at the whole period of 1980 through 1987. We will focus a lot on 1987, but we are also looking at the earlier years.

The total error, if you average it across the 8 years, is in the $40 billions. It is a very large error. Now, $10 billion to $15 billion of that is due to subsequent policy changes, and we will detail what they are. Part of it obviously lies in the economic assumptions—that is, the major part of it—and we will discuss that in detail.

I think you know that economic assumptions, since they include interest rates, are very hard for the estimators to get right. Also, there has been a special problem in the 1980s. When you consider the whole decade, economic growth has been a little disappointing, because of low productivity growth. And so all forecasters, and indeed all mechanical methods of forecasting, have proved to be optimistic on balance, even though at the time they were making their forecasts it did not look that way. But we will be working on that, too.

Senator DOMENICI. How long before you have that ready?

Dr. GRAMLICH. It will be about 3 weeks to a month. The material will be in our August update.

Senator DOMENICI. I think that is a very exciting document, Mr. Chairman, and I look forward to seeing it. And you will break it down as much as you can into things that we understand.

Dr. GRAMLICH. We will break it down, and we will also explain the technical reestimates. We have some good material there.

Senator DOMENICI. Mr. Chairman, do you mind if I go on just a couple more minutes?

Chairman CHILES. Go ahead.

DEFINITION OF TECHNICAL REESTIMATE

Senator DOMENICI. Give us your definition of technical reestimates so we will have it out here on the table.

Dr. GRAMLICH. You could say it is "everything else." In other words, you know what the deficit estimate was when the Congressional Budget Resolution was passed. You know what the final outcome is. You know how much of the difference is accounted for by subsequent legislation. You know what is attributable to inaccuracies in the economic assumptions. Everything else is called the technical reestimates.

Senator DOMENICI. For instance, there is an estimate of medicare outlays to be expected for a year. The estimate may be impacted by economics, but it also may be impacted by some things that the model does not take into consideration, such as participation rates.

Dr. GRAMLICH. Exactly.

Senator DOMENICI. And that means that something changed in terms of payments and eligibility.

Dr. GRAMLICH. Exactly.

Senator DOMENICI. Or was different than you assumed.

Dr. GRAMLICH. That is right.

Senator DOMENICI. CBO has to estimate those kinds of things, and you had to make some educated guesses, and some turn out right and some are wrong. Those are the kinds of things you are talking about.

Dr. GRAMLICH. That is right.

Senator DOMENICI. Are they essentially things you cannot do anything about?

Dr. GRAMLICH. I would not say that. It is a mixed bag. There are some technical reestimates on the revenue side, some on the outlay side. One reason for doing this, in addition to showing people what

kind of accuracy you can expect in these projections, is to help ourselves. If we find that we have been making persistent errors in estimating certain items, we want to try and improve our methods.

Senator DOMENICI. I have just three more quick questions. First of all, historically, CBO has made their own economic estimates; correct?

Dr. GRAMLICH. Right.

Senator DOMENICI. You have available to you the whole scenario of economic assumptions made out there in the marketplace. Some estimators do it as professionals for a living; others do it professionally for their own business reasons, and somehow out of that comes something that you as experts call a consensus forecast.

Dr. GRAMLICH. Right.

CONSENSUS NEVER GIVES COMPLETE FORECAST

Senator DOMENICI. Do you contemplate changing your forecasting method to some kind of consensus economic projection?

Dr. GRAMLICH. I would not say that we would go exactly to the consensus, but I would say that we are uncomfortable deviating a lot from the consensus. The approach that we have followed this time is that, on the critical real growth assumptions, both short-run and long-run, we do not deviate very much from the consensus. We cannot be exactly on it, because the consensus changes every 2 weeks, but we do not deviate very much from it. In filling in the rest of the forecast, the whole structure of interest rates and inflation and so forth, we try to be logically consistent within the forecast. In some cases, we use econometric methods and so forth.

So I would say that our forecast is roughly what the consensus is, but with a whole lot of blanks filled in by us because the consensus will never give you a complete forecast.

ESTIMATING OF OUTLAYS PRETTY GOOD

Senator DOMENICI. Could I ask you just two questions? How much progress do you think we, as a U.S. Government institution, are making in the art of estimating outlays? Are we doing better? Is it still a very precarious art? There are still some who contend we ought to forget about it; there are many of us who think it is absolutely impossible to forget about it, that it must be done.

Dr. GRAMLICH. I agree with the last point. I think it must be done. I am going to have trouble telling you how much progress we are making in the art of estimating outlays. But you will find when you see our numbers that, with a few exceptions, we are pretty good at estimating outlays. We still have some trouble spots, however. One is a long word beginning with "a"—agriculture; that has been a big thorn in our side. But other than that, we haven't done too badly.

Senator DOMENICI. My last question is this, even though it is going to take you another month to do this full-blown report. If the chairman agrees, I wonder if you could do the following for us. Would you go back 5, 6, 7 years, whichever you want, and take your February baseline and plot the actual deficits. Include your most current estimate for 1988, assume that is a reality. Then tell us where we would be if we would have made $36 billion in outlay

reductions by policy changes in each of those years off the February CBO estimate. Put that on one chart, and put where we ended up on another. Can you do that?

Dr. GRAMLICH. I think so.

Senator DOMENICI. How long do you think that will take?

Dr. GRAMLICH. I do not know, but we will do our best. There may be some snag, but I see what your drift is.

Senator DOMENICI. I hope you do.

Dr. GRAMLICH. There may be some snag in the calculation, but I can have somebody get to work on it.

Chairman CHILES. See what you can do for us.

Senator DOMENICI. Thank you very much, Mr. Chairman.

[The following was subsequently supplied for the record by CBO:]

COMPARISON OF DEFICITS

The first line of the following table shows actual deficits for fiscal years 1983–1986 and the current estimates for 1987 and 1988 (in billions of dollars). The second line shows what the deficit estimates would have been if $36 billion in deficit reduction had been made through policy changes each year, including fiscal year 1988.

	1983	1984	1985	1986	1987	1988
Deficit with actual policy changes	208	185	212	221	161	181
Deficit with assumed alternative policy changes	190	155	150	166	142	162

Depending upon the particular policies adopted, policy changes with first-year savings of $36 billion may result in either greater or lesser savings in later years. The calculation shown in the second line of the table assumes that each year's policy savings remain constant in succeeding years, except for additional reductions in debt-service costs.

Chairman CHILES. Senator Conrad?

Senator CONRAD. Let me just follow up on something that Mr. Miller said. Mr. Miller said that this is a year that we ought to be seeking perhaps more deficit reduction than next year because of the underlying numbers. Let me follow that thought through.

Dr. GRAMLICH. By "this" do you mean 1988?

BIGGER BITE OF APPLE NOT LOGICAL

Senator CONRAD. Yes; 1989 is going to be more troublesome. As I heard him, he was suggesting that you take a bigger bite at the apple in this particular year if there is a way of doing it. And I would like to know if you agree with that, that it could be easier to achieve deficit reduction in fiscal 1988 than fiscal 1989.

Dr. GRAMLICH. That is a hard question to answer. I think what was being referred to was the tendency of deficits to rise between the 2 years.

It does not really follow that because the deficit goes up, it is easier to take a big bite of the apple now. I think it is possible to make whatever deficit reduction you choose to make in any year, and the fact that the deficit goes from $181 billion to $198 billion or, in adjusted terms, from $171 billion to $179 billion, is not of inordinate importance. I mean, I think most of us agree that the deficit is too high——

Senator CONRAD. Yes; I assume that Mr. Miller was taking into account the political factors. I mean, obviously, there is more pain to be distributed when you have a bigger margin.

Dr. GRAMLICH. OK.

Senator CONRAD. Following that logic, if you start in fiscal 1986, the deficit was $221 billion; in fiscal 1987, it was $161 billion, your number. Now, in fiscal 1988, you are talking about a deficit of $151 billion based on the budget resolution that is passed. Is that correct?

[Dr. Gramlich nods.]

Senator CONRAD. So we would be only making $10 billion of reductions in the deficit from fiscal 1987 to 1988 if we hold to the budget resolution that is now passed.

Dr. GRAMLICH. If you want to look at it that way. I think that is a little bit misleading, however because it ignores the variations due to the tax bill. But obviously your math is right.

Senator CONRAD. And so if we were going to be taking a bigger bite of the apple this year, a deficit level of $151 billion, a $10 billion reduction year to year, would not be sufficient.

Dr. GRAMLICH. You would not get many hosannas for that, but since the baseline deficit rises in that year, in fact you would be making some progress.

$150 BILLION DEFICIT WOULD BE PLEASANT SURPRISE

Senator CONRAD. And what in your judgment would it take to send a signal to the marketplace that we were being serious about deficit reduction?

Dr. GRAMLICH. Speaking for CBO, I cannot really get into that. Speaking as a citizen, the casual impression one has is that if you could get the deficit down to $150 billion in 1988 a whole lot of people would be pleasantly surprised.

Senator CONRAD. If we could get it to what?

Dr. GRAMLICH. $150 billion.

Senator CONRAD. $150 billion.

Dr. GRAMLICH. In 1988, yes.

Senator CONRAD. Now, again, that is only $11 billion——

Dr. GRAMLICH. I know it is only $10 billion from 1987, but I think a whole lot of people would be pleasantly surprised.

Chairman CHILES. But what you would be really talking about if you look at your table 2, and if you take out tax reform and take out the one-time savings, you would really be moving that number of $194 billion down to $151 billion, which would be a $43 billion move. So that would be——

Dr. GRAMLICH. Could you go through that again?

Chairman CHILES. Well, I am looking at the 1987 table. As I say, if you take out the $18 billion tax reform and the one-time savings of the $16 billion, you are really talking about an adjusted deficit of $194 billion. And so if you have got that down to $151 billion, you would have made a major move.

Dr. GRAMLICH. Yes.

Senator GRAMM. But you have the $18 billion tax reform revenues.

Chairman CHILES. But you are making up for a $31 billion snift, because the next year you lose $13 billion.

Senator GRAMM. The only point I am making is you have reduced the deficit to $150 billion; if you want to take out the tax reform revenues, then you have actually lowered it to $168 billion.

Senator CONRAD. Right. Exactly. That is my point as well. I mean, the structural reduction is pretty modest in a year in which Mr. Miller makes the assertion is the year we ought to be taking a bigger bite of the apple. The fact is, we have got an economy that has got some strength right now. We have had expansion going on these 54 months; at some point we are probably going to run into a recession—and then what is going to happen?

What concerns me greatly is that if we only go to $151 billion off of a deficit in fiscal 1987 of $161 billion, it is going to take time to get to a balanced budget.

Dr. GRAMLICH. OK. I do not want to say anything to dissuade you from taking as big a bite from the apple as you can possibly take.

Senator CONRAD. My time has expired.

Chairman CHILES. Senator Gramm?

Senator GRAMM. Mr. Chairman, let me try to be brief. First of all, we are talking here as if these increases in interest rates came because God rained them down on us, and despite the fact that we have been good, it just happened. Why do you think interest rates are up?

Dr. GRAMLICH. I think what you are going to try to lead me to say is that it's partly due to worrying about whether Congress and the President are attacking the deficit with full fervor.

Senator GRAMM. If you are going to guess ahead of me, let me go ahead and ask. [Laughter.]

THESIS HAS VALIDITY

I want to ask your response to the following thesis. When we adopted this Gramm-Rudman-Hollings balanced budget law, the market responded—I want to give you a thesis and then ask whether you agree that it can have any validity, a lot of validity, a whole lot of validity—interest rates declined. Now, it may or may not have had anything to do with the law, but one thesis might be that the adoption of binding constraints, the setting of deficit targets and the setting of an automatic mechanism as a disciplining device, convinced the marketplace, going back to Mr. Conrad's question about sending messages to the market, that Congress was actually serious about deficit reduction. Therefore, expectations in the marketplace were adjusted. We have made progress with the deficit, some last year, a lot this year, with indications that we are no longer so serious about deficit reduction. People working in financial markets expect the President is going to veto reconciliation and know there are not any spending cuts, and know there is not going to be any tax increases, thus there is not going to be any deficit reduction.

So what we are seeing and have seen in the last 6 months is a reevaluation of expectations and that, in fact, much of our change in the baseline is due to our own failure.

How do you react to that?

Dr. GRAMLICH. The thesis hangs together, Senator.

Senator GRAMM. Nicely, I think.

What do you think of it?

Dr. GRAMLICH. I think that is something I would not want to be quoted on, but the thesis hangs together.

Our intended rate forecasts do reflect what the market is saying about short-term interest rates, about the pattern of interest rates, and so forth. And we all know that interest rates depend heavily on the market's valuing various things, such as what the deficit will be in the future. There is a lot of evidence for that. So in that sense, the two building blocks on which you are building this thesis are sensible. I cannot assert that they are correct, but they are certainly sensible. The thesis hangs together.

MEETING TARGETS WOULD HAVE PRODUCED LOWER INTEREST RATES

Senator GRAMM. Senator Domenici asked you to redo this table with this $36 billion worth of savings that never happened, and the permanent reoccurring savings.

Dr. GRAMLICH. Right, right.

Senator GRAMM. If those savings had happened, do you think interest rates would be higher or lower, other things being the same?

Dr. GRAMLICH. Lower.

Senator GRAMM. If we had met the first two or three Gramm-Rudman-Hollings targets, however we would have met them, other things being the same, would interest rates today be higher or lower?

Dr. GRAMLICH. Lower.

Senator GRAMM. You are getting an "A" in economics. [Laughter.]

BUY BACK WITHOUT PENALTY

I want to ask you a final question. Several times here, we have talked about the asset sale where we are in essence allowing people to buy back without a penalty REA loans.

Dr. GRAMLICH. Right.

Senator GRAMM. And of course, we went out and borrowed the money, and we did not have the right to buy those bonds back. We put in this penalty to protect the taxpayers against borrowers coming in and asking to pay it back now that interest rates are down.

As an economist, do you think that it is sound policy to waive the prepayment penalty and absorb the $2 billion present value loss on allowing these loans to be paid early?

Dr. GRAMLICH. Well, Senator, I would like to absent myself from the policy guidelines. Unlike OMB, we do not make policy recommendations, and I would like to stay out of that.

What I will say is that the CBO has long argued that it is essentially an asset sale; you are selling the asset to the initial borrower. CBO feels this really should not count as deficit reduction in any true sense, which is precisely why we did that table I described earlier, putting all those things in a separate category.

So we have taken a strong position on the deficit accounting of those types of things, but I would prefer not to comment on the wisdom of the policy.

Senator GRAMM. You might envision an analogy where a business might want to sell Conrail. But can you envision a business allowing loan prepayment without penalty and absorbing the loss?

Dr. GRAMLICH. I suppose you can envision it. I assume it happens sometimes on mortgages, for example. I do not know that it is unprecedented in modern life.

Senator GRAMM. Thank you, Mr. Chairman.

Chairman CHILES. Senator Exon?

INTEREST RATE PROJECTIONS

Senator EXON. Dr. Gramlich, we keep getting different projections and different charts, and we become preoccupied around here about the deficit and what it is doing to interest rates.

Right now, we have certainly the highest national debt in our history. Right now, we have one of the highest budget deficits in our history, and interest rates by and large are down considerably.

Who would have imagined 6 years ago, or 8 years ago, that we would have doubled the national debt from under $1 trillion to nearly $2.5 trillion, and the interest rate would be less than half of what it was then? Let me ask you this question. What do you really think we know about the effect of the deficit—as bad as I think it is—what do you think we really know about what direct effect that has on interest rates?

Or, putting it another way, in 1980 or thereabouts when we had a national debt under $1 trillion, approaching $2.5 trillion now, we had interest rates at that time at 20 percent, and we have interest rates today at less than half that. What does that say about our ability to make projections?

It seems to me that it knocks all of our traditional economic values into a cocked hat. Can you explain that?

Dr. GRAMLICH. I would be the first to stress the uncertainties in what we know about interest rates. We "know" very little about interest rates. But I think there are some areas where we have more knowledge than you give us credit for in your question.

One rule is that nominal interest rates depend a lot on the forecasted rate of inflation. What has happened between the 1970s and the 1980s—and with all this concern about deficits, it is nice to remind ourselves that in some ways the world has improved—is that the inflation rate has gone down. I think that most people who study interest rates would attribute a lot of the decline to that. The inflation premium built into interest rates is not so large now as it was then. When you subtract the inflation premium you get what economists call real interest rates. It is still a little hard to figure out what real interest rates are at present, because as has been pointed out here, so much depends on your forecast of inflation.

Now, in the manner of Senator Gramm, one could go through the 1980's and say that when the first scare stories began to appear about deficits, real interest rates rose a lot, and when it looked like we were getting things more under control, real interest rates fell;

now they may be going up, or whatever. But to a great extent those movements are based on expectations. One cannot say, the deficit was this amount in this year, and interest rates were that, and then the deficit was this in this year, and therefore interest rates were that. But this doesn't mean that we do not know anything at all—I would not be so agnostic as that. I think you can tell a story about both nominal interest and real interest rates in the 1980s, but you are not going to tell this story from week to week or month to month. Moreover, our interest rate projections may change in a few weeks. I hope not, but we may have to. There is an awful lot of uncertainty about it. But I think we understand the process a little bit.

NATIONAL DEBT SHOULD BE CORRECTED

Senator EXON. That was a lead up to my second question, then. Maybe you can explain this for me. I am not criticizing; I am just seeking some information, because sometimes I hope we rely on information as we project the answers to some of the problems that we see, real or imagined.

Right now we are looking at an inflation rate of 4 to 5 percent a year now and into the future; is that correct?

Dr. GRAMLICH. Yes.

Senator EXON. And right now we are looking at a national debt in the area of $3 trillion in the not too distant future; is that right?

Dr. GRAMLICH. Yes.

Senator EXON. And despite that, despite those figures, one which seems fairly reasonable, 4 to 5 percent inflation, is a lot more reasonable than 15 to 20 percent, but for the rest of the world it is a fairly reasonable figure. Yet we do have, even with that, a very high projected national debt where we have to go out and borrow the money to pay for that.

The stock market during the last few years has more than doubled. It seems to me that things are just going splendidly these days. We have a low inflation rate. We have declining interest rates. And yet we have a skyrocketing national debt, and everybody says, "But we are in a tragedy."

Explain that to me. If everything would remain the same as it is right now, with the constant growth that we heard from Mr. Miller about this morning, is it your view that we are overly concerned about this national debt problem, and that we should just leave well enough alone, or do you think we should try to correct it?

I happen to think we should correct it, but I am giving some examples here this morning that might say well, things are working so well right now—why rock the boat.

Dr. GRAMLICH. I agree with you that we ought to correct it, and I do not think that in all regards, things are working well right now.

One problem with the deficit has always been that it may make things better in the short run. It used to be argued that the deficit would lead to higher inflation and higher interest rates, but in what economists call an "open economy"—that is, where you have international capital movements and so forth—that is not necessarily true anymore. It used to be argued that deficits would crowd

out capital investment. Again, in this open economy, that may not be true——

Senator EXON. But that was when the United States of America was a creditor nation, rather than debtor nation. Isn't that a key?

NATIONAL SAVINGS RATE LOW

Dr. GRAMLICH. That is right. That is a key. And I would like to commend to your attention a statistic that I think is the right one to look at in this day and age—the share of total output that the United States is devoting to saving of all sorts. You can get that amount either by adding up domestic private saving and deducting the deficit from it, or by taking net investment and deducting from it the import surplus, which is really negative net investment. When you do that, you find that the situation is not very good, that national saving rates are roughly one-third of what they had been up until the start of the 1980s.

Senator EXON. Isn't our savings rate the lowest of the industrialized world?

Dr. GRAMLICH. It is, yes.

Senator EXON. My time is up. I thank you for your openness and candor. One last question. I would like to refer to table 2, Mr. Gramlich, "Effect of Tax Reform and One-Time Outlay Savings on Deficit by Fiscal Year". Under tax reform, you come down there in 1987 to $18 billion, then minus $13 billion, minus $17 billion, minus $4 billion, plus $2 billion, and then minus $1 billion in 1992. Doesn't that indicate that the tax reform bill indeed was not tax-neutral, but was something else?

Dr. GRAMLICH. The average over those years is a negative number, yes. That was not the estimate at the time.

Senator EXON. That was not the estimate of the director of your agency nor was it the estimate of the President's budget-makers, was it?

TAX BILL HAS ENORMOUS UNCERTAINTIES

Dr. GRAMLICH. Yes; CBO's estimates have not changed an awful lot—by an annual average of $3 billion to $4 billion, or something like that. Most of these changes are due to our new economic assumptions which, if we had had them at the time, would have enabled us to make even closer estimates——

Chairman CHILES. And we do not have any idea how these are going to turn out.

Dr. GRAMLICH. Oh, exactly. People are overwithholding a lot now, perhaps because nobody knows what the W-4 forms mean. And you have got the capital gains cash-in; nobody knows if that will be offset in revenue losses in the future. There is just enormous uncertainty. But we have downgraded the estimates of the tax bill.

Senator EXON. Dr. Gramlich, thank you very much. I just want to compliment your agency. I think you and your group have done a good job in the past. We rely very heavily on you, and so we have a lot of confidence in the fact that you are not going to be right, but probably closer to right than any of the other forecasters.

Thank you.

Dr. GRAMLICH. Thank you, Senator.

Chairman CHILES. Dr. Gramlich, I want to ask you one more question. We thank you for your patience, and we were late getting you on.

PERMANENT DEFICIT REDUCTIONS MADE

In the past few years, true deficit savings enacted by the Congress and approved by the President were relatively meager. How do the actual savings in this year's budget resolution compare to actual policy changes—policy changes, now—which reduce the structural deficit made by the Congress in 1985, 1986, and 1987?

Dr. GRAMLICH. We have those numbers, and again I give you the option of having me flip through and find them, or supply them later.

Chairman CHILES. If you could find them quickly for me, I would like to have them.

Dr. GRAMLICH. We have prepared something that is entitled, "Policy Changes Since Early 1985." Do you want me to talk about the 1987 deficit?

Chairman CHILES. How would they compare with this year's budget resolution, with 1985, 1986, and 1987?

Dr. GRAMLICH. OK. I will give you the numbers for policy changes. It goes plus $2 billion for 1985, minus $15 billion for 1986, minus $91 billion for 1987, and minus $84 billion for 1988.

Now, if we take out the one-time reductions—the nonrecurrent changes—you have a new set of numbers that are $2 billion, minus $13 billion, minus $57 billion, and so on. And we have tables that tell you what they all are, that break it up into the various particular actions. I think that is what you want, isn't it, Senator?

Chairman CHILES. So the actual policy changes that were made by the Congress in 1984 were plus $2 billion, did you say——

Dr. GRAMLICH. Made since 1985, in 1985. But if we are talking about the impact on the 1987 budget, actually, there have been permanent deficit reductions on the order of $57 billion in fiscal year 1987, for example. That is, apart from these nonrecurrent things.

So the answer is yes, there have been permanent deficit reductions.

Chairman CHILES. Right. But the first-year number for 1985 was plus $2 billion, you say?

Dr. GRAMLICH. Yes.

Chairman CHILES. What was the first-year number for 1986?

Dr. GRAMLICH. Well, I do not have a first-year number, but rather the cumulative effect of all of the changes made since 1985.

Chairman CHILES. So you do not have those numbers, just to try to find out what policy changes Congress actually made in 1986, what those first-year policy changes would be.

Dr. GRAMLICH. I had better supply those to you later. It is pretty tricky.

[The following was subsequently supplied for the record by CBO:]

FIRST YEAR POLICY CHANGES

First-year policy changes increased the deficit by $2 billion in fiscal year 1985 and reduced the deficit by $17 billion in 1986 and $45 billion in 1987. Excluding one-time

savings and tax reform, enacted first-year deficit reductions totalled $11 billion in fiscal year 1985, $17 billion in 1986, and $16 billion in 1987.

Chairman CHILES. All right. Thank you. I have some other questions for the record.

We thank you very much, and we will recess this hearing at the call of the Chair.

[Whereupon, at 1 o'clock p.m., the committee was adjourned.]

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